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The Toll of Economic War

How Sanctions on Russia Will Upend the Global Order

By Nicholas Mulder

The Russian-Ukrainian war of 2022 is not just a major geopolitical event but also a geoeconomic turning point. Western sanctions are the toughest measures ever imposed against a state of Russia's size and power. In the space of less than three weeks, the United States and its allies have cut major Russian banks off from the global financial system; blocked the export of high-tech components in unison with Asian allies; seized the overseas assets of hundreds of wealthy oligarchs; revoked trade treaties with Moscow; banned Russian airlines from North Atlantic airspace: restricted Russian oil sales to the United States and United Kingdom; blocked all foreign investment in the Russian economy from their jurisdiction; and frozen $403 billion out of the $630 billion in foreign assets of the Central Bank of Russia. The overall effect has been unprecedented, and a few weeks ago would have seemed unimaginable even to most experts: in all but its most vital products, the world's eleventh-largest economy has now been decoupled from twenty-first-century globalization.

How will these historic measures play out? Economic sanctions rarely succeed at achieving their goals. Western policymakers frequently assume that failures stem from weaknesses in sanctions design. Indeed, sanctions can be plagued by loopholes, lack of political will to implement them, or insufficient diplomatic agreement concerning enforcement. The implicit assumption is that stronger sanctions stand a better chance of succeeding.

Yet the Western economic containment of Russia is different. This is an unprecedented campaign to isolate a G-20 economy with a large hydrocarbon sector, a sophisticated military-industrial complex, and a diversified basket of commodity exports. As a result, Western sanctions face a different kind of problem. The sanctions, in this case, could fail not because of their weakness but because of their great and unpredictable strength. Having grown accustomed to using sanctions against smaller countries at low cost, Western policymakers have only limited experience and understanding of the effects of truly severe measures against a major, globally connected economy. Existing fragilities in the world's economic and financial structure mean that such sanctions have the potential to cause grave political and material fallout.

THE REAL SHOCK AND AWE

Just how severe the current sanctions against Russia are can be seen from their effects across the world. The immediate shock to the Russian economy is the most obvious. Economists expect Russian GDP to contract by at least 9–15 percent this year, but the damage could well become much more severe. The ruble has fallen more than a third since the beginning of January. An exodus of skilled Russian professionals is underway, while the capacity to import consumer goods and valuable technology has fallen drastically. As Russian political scientist Ilya Matveev has put it, "30 years of economic development thrown into the bin."

The ramifications of the Western sanctions go far beyond these effects on Russia itself. There are at least four different kinds of broader effects: spillover effects into adjacent countries and markets; multiplier effects through private-sector divestment; escalation effects in the form of Russian responses; and systemic effects on the global economy.

Spillover effects have already caused turmoil in international commodities markets. A generalized panic erupted among traders after the second Western sanctions package—including the SWIFT cutoff and the freezing of central bank reserves—was announced on February 26. Prices of crude oil, natural gas, wheat, copper, nickel, aluminum, fertilizers, and gold have soared. Because the war has closed Ukrainian ports and international firms are shunning Russian commodity exports, a grain and metals shortage now looms over the global economy. Although oil prices have since dropped in anticipation of additional output from Gulf producers, the price shock to energy and commodities across the board will push global inflation higher. African and Asian countries reliant on food and energy imports are already experiencing difficulties.

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Central Asia's economies are also caught up in the sanctions shock. These former Soviet states are strongly connected to the Russian economy through trade and outward labor migration. The collapse of the ruble has caused serious financial distress in the region. Kazakhstan has imposed exchange controls after the tenge, its currency, fell by 20 percent in the wake of the Western sanctions against Moscow; Tajikistan's somoni has undergone a similarly steep depreciation. Russia's impending impoverishment will force millions of Central Asian migrant workers to seek employment elsewhere and dry up the flow of remittances to their home countries.

The impact of the sanctions goes beyond decisions taken by G-7 and EU governments. The official sanctions packages have had a catalyzing effect on international businesses operating in Russia. Virtually overnight, Russia's impending isolation has set in motion a massive corporate flight. In what amounts to a vast private sector boycott, hundreds of

major Western firms in the technology, oil and gas, aerospace, car, manufacturing, consumer goods, food and beverage, accounting and financial, and transport industries are pulling out of the country. It is noteworthy that these departures are in many cases not required by sanctions. Instead, they are driven by moral condemnation, reputational concerns, and outright panic. As a result, the business retreat is deepening the economic shock to Russia by multiplying the negative economic effects of official state sanctions.

The Russian government has responded to the sanctions in several ways. It has undertaken emergency stabilization policies to protect foreign exchange earnings and shore up the ruble. Foreign portfolio capital is being locked into the country. While the stock market has remained closed, the assets of many Western firms that have departed may soon face confiscation. The Ministry of Economic Development has prepared a law that grants the Russian state six months to take over businesses in case of an "ungrounded" liquidation or bankruptcy.

The potential nationalization of Western capital is not the only escalatory effect of the sanctions. On March 9, Putin signed an order restricting Russian commodity exports. Although the full array of items to be withheld under the ban is not yet clear, the threat of its use will continue to hang over international trade. Russian restrictions on fertilizer exports imposed in early February have already put pressure on global food production. Russia could retaliate by restricting exports of important minerals such as nickel, palladium, and industrial sapphires. These are crucial inputs for the production of electrical batteries, catalytic converters, phones, ball bearings, light tubes, and microchips. In the globalized assemblage system, even small changes in materials prices can massively raise the production costs faced by final users downstream in the production chain. A

Russian embargo or large export reduction of palladium, nickel, or sapphires would hit car and semiconductor manufacturers, a $3.4 trillion global industry. If the economic war between the West and Russia continues further into 2022 at this intensity, it is very possible that the world will slide into a sanctions-induced recession.

MANAGING THE FALLOUT

The combination of spillover effects, negative multiplier effects, and escalation effects means that the sanctions against Russia will have an effect on the world economy like few previous sanctions regimes in history. Why was this great upheaval not anticipated? One reason is that over the last few decades, U.S. policymakers have usually deployed sanctions against economies that were sufficiently modest in size for any significant adverse effects to be contained. The degree of integration into the world economy of North Korea, Syria, Venezuela, Myanmar, and Belarus was relatively modest and one-dimensional. Only the rollout of U.S. sanctions against Iran required special care to avoid upsetting the oil market. In general, however, the assumption held that sanctions use was economically almost costless to the United States. This has meant that the macroeconomic and macrofinancial consequences of global sanctions are insufficiently understood.

To better grasp the choices to be made in the current economic sanctions against Russia, it is instructive to examine sanctions use in the 1930s, when democracies similarly attempted to use them to stop the aggression of large-sized autocratic economies such as Fascist Italy, imperial Japan, and Nazi Germany. The crucial backdrop to these efforts was the Great Depression, which had weakened economies and inflamed nationalism around the world. When Italian dictator Benito Mussolini invaded Ethiopia in October 1935, the League of Nations implemented an international sanctions regime enforced by 52 countries. It was an

impressive, united response, similar to that on display in reaction to Russia's invasion of Ukraine.

But the league sanctions came with real tradeoffs. Economic containment of Fascist Italy limited democracies' ability to use sanctions against an aggressor who was more threatening still: Adolf Hitler. As a major engine of export demand for smaller European economies, Germany was too large an economy to be isolated without severe commercial loss to the whole of Europe. Amid the fragile recovery from the Depression, simultaneously placing sanctions on both Italy and Germany—then the fourth- and seventh-largest economies in the world—was too costly for most democracies. Hitler exploited this fear of overstretch and the international focus on Ethiopia by moving German troops into the demilitarized Rhineland in March 1936, advancing further toward war. German officials were aware of their commercial power, which they used to maneuver central European and Balkan economies into their political orbit. The result was the creation of a continental, river-based bloc of vassal economies whose trade with Germany was harder for Western states to block with sanctions or a naval blockade.

The sanctions dilemmas of the 1930s show that aggressors should be confronted when they disrupt the international order. But it equally drives home the fact that the viability of sanctions, and the chances of their success, are always dependent on the global economic situation. In unstable commercial and financial conditions, it will be necessary to prioritize among competing objectives and prepare thoroughly for unintended effects of all kinds. Using sanctions against very large economies will simply not be possible without compensatory policies that support the sanctioners' economies and the rest of the world.

More intensive sanctions will inflict further damage to the world economy.

The Biden administration is aware of this problem, but its actions so far are inadequate to the scale. Washington has attempted to reduce strains in the oil market by a partial reconciliation with Iran and Venezuela. Countering the spillover effects of sanctions against one leading petrostate may now require lifting sanctions on two smaller petrostates. But this oil diplomacy is insufficient to meet the challenge posed by the Russia sanctions, the effects of which are aggravating preexisting economic woes. Supply chain issues and pandemic-era bottlenecks in global transport and production networks predated the war in Ukraine. The unprecedented use of sanctions in these already troubled conditions has made an already difficult situation worse.

The problem of managing the fallout of economic war is greater still in Europe. This is not only because the European Union has much stronger trade and energy links with Russia. It is also the result of the political economy of the eurozone as it has taken shape over the last two decades: with the exception of France, most of its economies follow a heavily trade-reliant, export-focused growth strategy. This economic model requires foreign demand for exports while repressing wages and domestic demand. It is a structure that is very ill suited to the prolonged imposition of trade-reducing sanctions. Increasing EU-wide renewable energy investment and expanding public control in the energy sector, as French President Emmanuel Macron has announced, is one way to absorb this shock. But there is also a need for income-boosting measures for consumer goods and price-dampening interventions in producer goods markets, from strategic reserve management to the excess profits taxes that are being rolled out in Spain and Italy.

Then there are the consequences of sanctions cause for the world economy at large, especially in the "global South." Addressing these problems will pose a major

macroeconomic challenge. It is therefore imperative for the G-7, the European Union, and the United States' Asian partners to launch bold and coordinated action to stabilize global markets. This can be done through targeted investment to clear up supply bottlenecks, generous international grants and loans to developing countries struggling to secure adequate food and energy supplies, and large-scale government funding for renewable energy capacity. It will also have to involve subsidies, and perhaps even rationing and price controls, to protect the poorest from the destructive effects of surging food, energy, and commodity prices.

Such state intervention is the price to be paid for engaging in economic war. Inflicting material damage at this scale levelled against Russia simply cannot be pursued without an international policymaking shift that extends economic support to those affected by sanctions. Unless the material well-being of households is protected, political support for sanctions will crumble over time.

THE NEW INTERVENTIONISTS

Western policymakers thus face a serious decision. They must decide whether to uphold sanctions against Russia at their current strength or to impose further economic punishment on Putin. If the goal of the sanctions is to exert maximum pressure on Russia with minimal disruption to their own economies—and thus a manageable risk of domestic political backlash—then current levels of pressure may be the most that is politically feasible now.

At the moment, simply maintaining existing sanctions will require active compensatory policies. For Europe especially, neither laissez-faire economic policies nor fiscal

fragmentation will be sustainable if the economic war persists. But if the West decides to step up the economic pressure on Russia further still, far-reaching economic interventions will become an absolute necessity. More intensive sanctions will inflict further damage, not just to the sanctioners themselves but to the world economy at large. No matter how strong <u>and justified</u> the West's resolve to stop Putin's aggression is, <u>policymakers must accept</u> <u>the material reality</u> that an <u>all-out economic offensive</u> will introduce considerable new strains into the world economy.

An intensification of sanctions will cause a cascade of material shocks that will demand far-reaching stabilization efforts. And even with such rescue measures, the economic damage may well be serious, and the risks of strategic escalation will remain high. For all these reasons, it remains vital to pursue diplomatic and economic paths that can end the conflict. Whatever the results of the war, the economic offensive against Russia has already exposed one important new reality: the era of costless, risk-free, and predictable sanctions is well and truly over.

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