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Breaking the Code: Principles Governing Sanctions Against Russia

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OVERVIEW

Bottom Line: The use of financial and economic sanctions against Russia demonstrates their power to penalize countries with globally integrated markets. We now need a strategy for convincing other countries (and markets) that this new weapon will be reserved for combating serious violations of international norms and not used as leverage in conventional commercial disputes. A code of best practice or principles could help guide the use of sanctions.

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In debating the consequences of Western sanctions on Russia, some observers voice concerns that sanctions are becoming an easy option for the United States and its allies when conflicts emerge. In a war-weary world, sanctions are an attractive alternative to military action, and, as I have argued elsewhere, the Russia experience has demonstrated the power of financial sanctions to impose costs on large, globally integrated economies. By imposing sanctions, Western powers wanted to send a strong signal to Russia (and to other countries contemplating similar actions) that there was a price to be paid for its violation of Ukrainian sovereignty and continued destabilization of the region. The United States and Europe may also have wanted to send a broader message: governments should adhere to basic international norms if they wish to participate in global markets. But concerns have now risen regarding which norms will be defended and how. What constitutes an egregious violation of international rules?

I have been an advocate of comprehensive sanctions in order to impose substantial up-front costs on Russia. I have also argued that there is inevitable momentum for an extension of sanctions in this case, both as a response to Russia's actions in Ukraine and to its evasion of sanctions announced earlier. I still see this expansion as appropriate, although I recognize the costs to U.S. and European interests. However, it is also important that sanctions advocates address the risks of extension, including the concern that certain measures to increase sanctions could disrupt global markets to a greater extent than previously witnessed. Already there are reports of market makers pulling back on risk positions over concerns of a broader lack of liquidity should sanctions be extended to current payments. Such concerns can act as a brake on international cooperation and encourage countries to limit their integration in global markets as an insurance policy against future sanctions. More broadly, such considerations may increase efforts to create new international institutions, such as the Asian Investment Infrastructure Bank (AIIB), which risk fragmenting the framework for global economic governance if not properly coordinated with existing international financial institutions, such as the World Bank and Asian Development Bank.

These concerns about the future overuse of financial sanctions fall into three basic categories:

- *Are financial sanctions too easy to implement?* Sanctions could become an easy option that is too readily applied in future cases. Although sanctions have not brought about peace in Ukraine, I would argue that the effects on Russia are significant and the costs will rise over time as capital outflows continue, investment in Russia is discouraged, and lost confidence contributes to a low-growth, high-inflation outcome for the Russian economy. Historically, it was assumed that a strong international consensus was needed for sanctions to be effective. That may be less true now; the power of sanctions stems from a country's exclusion from financial markets, providing some scope for the United States to go it alone.

- *Is the United States at risk?* Other countries may find their inhibitions lowered on the use of sanctions, making the United States a possible future target. One could imagine that, for example, countries opposed to U.S. policy on Taiwan or the Middle East might impose sanctions citing the Russian example.

- *How far is too far?* Once sanctions have been imposed, the pressure to extend them could lead to excessive use. In the Russian context, this debate revolves around whether sanctions should be imposed on the payments system. To some, the payments system is a global public good that needs to be protected, which suggests that a higher standard should be set for sanctions in this area. Unlike a prohibition on oil drilling by foreign companies, for example, a restriction on Russia's access to the payments systems reduces the benefits to other users across the globe.

THE POLICY RESPONSE

The United States and its allies no doubt value their options in the current environment. Indeed, the ambiguity about what could come next creates an additional cost for those considering doing business in Russia, which constitutes an important element of the effectiveness of sanctions. But that same ambiguity is a source of concern and can contribute to a loss of legitimacy. Can this leverage be preserved while assuring the rest of the world that sanctions will be used judiciously and appropriately?

The strategy for addressing these concerns may have relied on other governance reforms, such as International Monetary Fund (IMF) quota reform and market-strengthening initiatives—including a Doha Round agreement, the Trans-Pacific Partnership (TPP), and the Transatlantic Trade and Investment Partnership (TTIP)—to signal U.S. commitment to an open, thriving, and rules-based global marketplace. Unfortunately, all these initiatives appear to be in trouble, as does the global trade liberalization agenda more broadly.

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Better communication can also be part of the strategy. It was inevitable, given the complexity of the standoff in Ukraine and the need to build alliances with the Europeans, that policy would have to evolve in ways that were not always transparent to markets. Now that the United States and its European allies have more experience, there is an opportunity to distill lessons and explain the policy both to other countries and to the broader public.

A conversation with allies about the principles behind sanctions comes at a useful time. Some European countries are experiencing fraying support for sanctions, perhaps associated with differential costs from the sanctions and concerns about an energy shortage if the dispute extends into winter. With sanctions at current levels, these tensions can be mitigated, but opposition could intensify should the U.S. government decide to extend sanctions.

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A more ambitious idea would be to explore the possibility of a global code of conduct, or rules of engagement, which specifies—in a more concrete fashion than has been done to date—the conditions that could lead to the imposition of sanctions by the United States and its allies.

There are other examples of informal codes in the economic sphere that can provide inspiration. The Santiago Principles, for example, are a set of twenty-four voluntary guidelines for investments by sovereign wealth funds that were agreed to by a broad range of countries in 2008—both those with sovereign wealth funds and those receiving investments. The analogy is not direct, as the Santiago Principles focused on ensuring that states acted in a commercial manner and avoided destructive competition through commitments regarding disclosure, transparency, regulation, and governance. Nevertheless, there are some interesting parallels. First, the codes were voluntary and designed to respect the sovereignty and independence of the state-owned investment funds and the need to maintain control over investment choices. Second, the goal was to encourage better international standards and establish best practices to promote accountability and transparency. These principles have been successful in framing the investor behavior of these funds and also in clearing away some of the uncertainty and ambiguity surrounding these organizations.

Any code of conduct would need to promote transparency regarding the decision to impose sanctions and their application, objectives, and conditions for removal. This code would discourage retaliatory measures and tit-for-tat responses that could prove destructive. It may be a bridge too far to seek agreement on a specific code. But even in this case, the effort to articulate goals and objectives could help stabilize markets and address the concerns of important U.S. allies.

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