Statement by Daleep Singh

Assessing the Use of Sanctions in Addressing National Security and Foreign Policy Challenges

Subcommittee on National Security, International Development and Monetary Policy

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Chairman Cleaver and Ranking Member Stivers, thank you for the opportunity to appear before this committee.

As a Treasury official, I worked extensively on the design of Russia sanctions in 2014. I draw three main conclusions from the experience: (1) well-designed sanctions are highly effective at imposing costs on a market-based economy; (2) signals from our top leadership are often more potent than sanctions themselves; and (3) sanctions are rarely enough, by themselves, to achieve the foreign policy objective - especially when we're confronting an entrenched autocrat.

Bearing these lessons in mind, I will offer suggestions on how we might respond to Russia's continued aggression in the current context. As background, allow me to share perspective from the 2014 experience.

How were sanctions designed in 2014?

Before 2014, the United States had never imposed sanctions on a country the size of Russia. It was the tenth largest economy in world, with a GDP roughly the size of Italy. More important than its size was the complexity of Russia's economy and its connections to the rest of the world. Russia was and is of systemic importance in global energy markets, ranking second and third in the production of natural gas and oil, respectively. Its largest banks were comparable in size and complexity to Lehman Brothers before 2008. Given the high stakes involved, our objective was to design a menu of sanctions options that could deliver economic costs while limiting spillovers to the U.S. and global economy.[1]

We began pursuing this objective by first writing down a set of guiding principles that remain instructive today. Sanctions against a large, complex, and integrated market economy such as Russia should be: (1) powerful enough to demonstrate U.S. resolve and our capacity to impose overwhelming economic costs; (2) responsible to limit contagion through the U.S. and global financial system; (3) targeted to avoid the appearance of punishing the civilian population and, in doing so, strengthening the autocrat's domestic narrative; (4) calibrated to increase the chance of partnering with allies; and (5) staged to preserve scope for escalation or de-escalation, depending on the target's response and lessons learned from previous steps.

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[1] Maximizing economic costs against Russia (i.e., causing a financial crisis) was never our objective.

Putting these principles into action required an understanding of Russia's economic pressure points. We focused on asymmetries. Where did U.S. economic leverage intersect with Russia's economic vulnerability? Financial capital was and is an obvious choice. U.S. and European firms are the dominant global suppliers of financing that Russia needed and could not easily replace from other sources. Similarly, in energy, Russia's production is dependent upon U.S. and European technology to boost long-term capacity. Here again, U.S. and EU companies are major suppliers of something that Russia needed and cannot easily replace.

Financing restrictions proved especially potent

Restricting foreign capital proved even more potent than we anticipated. By removing the U.S. and European supply of debt and equity financing to the largest Russian state-owned enterprises in the most critical sectors of the economy, the 2014 sanctions triggered a negative feedback loop in Russia that ultimately led to a deep recession and double-digit inflation.

The mechanism was the reversal of market-based financing. For sanctioned entities, we prohibited the supply of Western capital through debt and equity issuance. Closing access to external financing spiked the borrowing cost for sanctioned targets to distressed levels. The sudden impairment of balance sheets in the largest sectors of Russia's economy spilled over to the corporate sector more broadly and sparked record levels of capital flight from the country as a whole.

In a futile attempt to defend its currency, the ruble, the Russian central bank depleted about a quarter of its foreign currency reserves before surrendering to market forces and allowing the ruble to depreciate close to fifty percent from its pre-sanctions value. Importantly, the speed of deterioration in Russia's financial markets was determined by investor choice and Putin's own defiance, rather than prescribed in advance by U.S. policy.

Punishing impact to the Russian economy followed soon afterwards. Import prices surged in tandem with Russia's weakened currency and pushed the inflation rate up to the mid-teens, forcing several rounds of emergency interest rate hikes by the Russian central bank. Banks required government injections of capital and regulatory forbearance just to avoid bankruptcy. Adjusted for inflation, wages and spending collapsed. Bank lending and investment dried up. The economy fell into recession.

Spillover risks were managed carefully

By late 2014, our sanctions program had the potential to deliver a knockout blow, particularly with lower oil prices causing an even larger shock.[2] Instead we showed restraint – both to increase the staying power of sanctions and to avoid the appearance of targeting Russian civilians. Our sanctions program only targeted a handful of state-

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[2] Most credible estimates are that 10 to 40 percent of Russia's economic contraction during this period was due to sanctions, with lower oil prices playing the larger role.

owned companies in key sectors. We did not target private companies, nor did we sanction all sectors of the Russian economy. We prohibited new flows of financing to sanctions targets, but existing stocks of risk[3] were not frozen. U.S. investors remained free to reduce exposure to Russia at a pace and magnitude of their choosing. Derivatives and money markets, both of which tend to be the 'dry tinder' of financial crisis, were largely untouched to avoid accidents in the global economy.

<u>Sanctions "do their job": impact and spillovers were largely as expected</u>

Due in large part to this restraint, the economic impact to and spillovers from Russia were in line with our expectations. The Russian economy contracted 2.5 percent in 2015, the biggest decline among large economies, and the recession continued into 2016.

Over the medium term, these sanctions dealt a weak strategic hand to Putin's economy. Russia's already depleted stock of capital was starved of much-needed financing and investment. Removal of U.S. and European energy technology, and the de-integration of Russia from the global financial system, deprived Russia of productive capacity and made its economy even more brittle. The chilling effect across the economy prompted defections from talented portions of Russia's already declining labor force. As of last September, the IMF estimated potential growth in Russia over the medium-term at no more than 1.5 percent per year, well below the average for emerging economies.

Meanwhile, unwanted spillovers were minimal. Sanctions forced the Russian government to spend a sizeable portion of its resources to contain economic stress, but we avoided causing widespread panic among the general public. This was consistent with our purpose: to create diplomatic leverage and deal space for our political leadership, not to deliver financial hardship for the Russian people.

Blowback to the U.S. economy was limited in the aggregate, although certain businesses and sectors were negatively affected. (By construction, sanctions are an economic distortion; spillovers are unavoidable). Even for Europe, where direct linkages to Russia are far more significant than in the U.S., the spillovers were summarized by the European Commission as "contained."[4] Were it not for sanctions, I believe the paralyzing uncertainty brought about by unchecked Russian aggression in the heart of Europe would have caused far more economic damage to the region.

<u>Signals were at least as important as actions</u>

Throughout this process, both the impact and spillovers from sanctions were managed through signaling. The signals were expressed by the most senior leaders of the U.S. government, and their force was multiplied by international partnership.

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[3] This was our way of respecting the sanctity of contracts.

[4] 0.3 percent of GDP in 2014 and 0.4 percent in 2015. *Russia's and the EU's sanctions: economic and trade effects, compliance and the way forward*
http://www.europarl.europa.eu/RegData/etudes/STUD/2017/603847/EXPO_STU(2017)603847_EN.pdf

In March 2014, after announcing the first round of sanctions against Russia, President Obama signaled the possibility of further escalation with a new executive order that authorized broader sanctions against key sectors of the Russian economy. In the same statement, he pushed forcefully in favor of an IMF bailout program for Ukraine's economy – a recognition that the best defense against Russian aggression was a strong economic offensive. Vice President Biden was dispatched to the Baltic states to reinforce our Article 5 commitment to NATO countries, and to step up cooperation with Europe on developing buffers against energy shortfalls in the region.

After announcing sanctions in July 2014 against Russia's largest banks, energy companies, and defense firms, President Obama warned again that the costs on Russia would ratchet higher if Putin's aggression in Ukraine continued. He also signaled that European allies were poised to mimic our sanctions program after close consultations (which they did, multiplying the direct effect of sanctions and reducing the competitive disadvantage to U.S. firms). Intensifying threats of escalation were expressed by President Obama in September after another round of sanctions, this time targeted at Russia's largest bank, even amid diplomatic efforts in Minsk to broker a ceasefire.

Looking back, I have no doubt that direct signaling from the U.S. President was among the most potent sanctions tools we deployed against Russia. This is not just a matter of opinion. Many of the most punishing episodes in Russian markets during 2014 were not the result of sanctions *actions* being announced, but rather they occurred after new *signals* about future actions were expressed by the President. This makes intuitive sense. Markets are shaped by expectations about the future; the past and present are already in the price.

Escalatory signals from the President provided new information that markets had yet to incorporate into prices, and these signals were invariably strong enough to impose costs on Russian markets *by themselves*. Of course this signaling would have lost its potency had investors doubted the credibility of the threat, but this has only become a relevant concern more recently.

<u>Sanctions can change behavior, but not by themselves</u>

Did these economic costs ultimately matter to Putin? Answering this question goes beyond my expertise, but I would observe that any leader – however rogue – cares about popularity, and recessions do not win hearts and minds among cronies, nor with the general public. It's certainly true that Putin's tolerance for economic pain is higher than that of most Western leaders, but there was threshold above which his decision-making calculus appeared to change.

Close observers have argued convincingly that were it not for the mounting costs to the Russian economy in late 2014, Putin's forces might have annexed more territory or

marched all the way to Kyiv.[5] We'll never prove the counterfactual, but by the Russian leadership's own admission the impact of sanctions was painful during this period.[6] My takeaway is that sanctions have the potential to overwhelm Putin's endurance, but only if they are backed with clear and unified signals from our top leadership – and embedded into a broader strategy. Ultimately, Putin is more tactical opportunist than grand strategist – costs matter.

A key caveat is the importance of winning the narrative within Russia. If there was a major failing in our 2014 sanctions regime, it was that the average Russian citizen did not see our purpose as honorable or even lawful.[7] Instead of believing our objective was to defend the free will of a sovereign Ukraine, the average Russian likely bought Putin's propaganda that U.S. sanctions were just the latest in a series of historical injustices perpetrated by the West upon Russia.[8] Our inability to counter Putin's scapegoating dampened the effects of sanctions on Russia's political economy and gave the regime far more staying power than it would have enjoyed otherwise.

Current context

Turning to the current context, we know that Russia's aggression abroad and repression at home have only worsened since 2015. At the same time, economic developments in Russia have improved markedly. The economy is out of recession; while it's still growing slowly, Russia's GDP grew in 2018 by the fastest amount in six years. Inflation touched an all-time low last year. Oil production also set a new post-Soviet record in 2018. Foreign reserves are back to pre-sanctions levels, nearing $500 billion in total. Both the government's budget surplus and trade surplus have reached record levels.

Financial conditions have taken a similarly positive turn. In February, Moody's upgraded Russia's sovereign debt to investment-grade. In March, the Russian government placed the largest amount of dollar issuance since 2013. Foreign investors have been major buyers of Russian debt sales, absorbing almost half of all issuance according to official sources.[9] The Russian ruble and Russian stock market are both among the top performers in the world this year.

Rising oil prices are undoubtedly driving part of the rebound, but so is the perception that the U.S. lacks the political will to stand up to Putin. Markets are reading the

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[5] Testimony of Ambassador Michael McFaul, https://www.banking.senate.gov/download/mcfaul-testimony-09-06-18

[6] "Ruble falls, sanctions hurt Russia's economy: Medvedev," *Reuters.* https://www.reuters.com/article/us-russia-medvedev-sanctions/rouble-fall-sanctions-hurt-russias-economy-medvedev-idUSKBN0JO0SR20141210

[7] https://www.levada.ru/2016/08/18/sanktsii-zapada-i-produktovoe-embargo-rossii/

[8] "A year into a conflict with Russia, are sanctions working," *Washington Post.* https://www.washingtonpost.com/world/europe/a-year-into-a-conflict-with-russia-are-sanctions-working/2015/03/26/45ec04b2-c73c-11e4-bea5-b893e7ac3fb3_story.html?utm_term=.b745d8e51f79

[9] "Foreign buyers bought just over half of all Russia's OFZ bonds issued in Q1 2019," *Intellinews.* https://www.intellinews.com/foreign-investors-bought-just-over-half-of-all-russia-s-ofz-bonds-issued-in-1q19-158907/

signals, but unlike in 2014 they are muting rather than amplifying the impact of sanctions. President Trump has repeatedly questioned the findings of our top intelligence officials about Russia's attack on our democratic process in 2016. President Trump says it would be a good thing to get along with Russia, despite Putin's desire to undermine our national interests in Ukraine, Syria, and Venezuela. He congratulated Putin on his re-election even amid outrage over Russia's brazen chemical attacks on NATO soil. Investors see the sanctions tool being applied to the limit against rogue regimes in Iran and Venezuela, but when it comes to Russia, they read stories of sanctions fatigue – even within the U.S. Congress. If I were to summarize the general market attitude towards the U.S. government's Russia sanctions program, it would be described as political theater, an unserious show of concern without any real desire for policy action behind the scenes.

In a practical sense, that's the good news – expectations for U.S. sanctions are low, and greed has overtaken fear in the pricing of Russian assets. Perhaps more now than at any point since 2014, new Russia sanctions would be a surprise blow to markets and make a real difference. I suggest two immediate actions:

- First, U.S. investors should be prohibited from purchasing new Russian sovereign debt in any currency. In 2014, I was cautious about taking this action due to the unpredictable spillover effects of disrupting the risk-free, benchmark asset of a sovereign nation. Circumstances have changed. Russia is far better able to absorb a hit to its sovereign debt market, for the reasons described above, and investors have had almost five years to reduce exposures in Russia. More to the point, I can think of no credible argument why U.S. public pension funds and household 401Ks should fund the Russian government after its "sweeping and systematic" attempts to undermine American democracy.[10]

- Second, while I am not in favor of prohibitions on secondary market trading[11] of Russian assets as a general matter, there is merit in constructive ambiguity. Requirements on U.S. persons to disclose any existing holdings of Promsyvazbank (Russia's designated bank to service the defense sector), and possibly VEB, would generate a broader chilling effect. By itself, this measure would not prohibit any trading activities, but markets are conditioned to read the signals that broader restrictions could follow. Note: these financial institutions are essentially appendages of the Russian government, oriented around domestic lending and with relatively limited international linkages.

[10] See Volume 1: Report On The Investigation Into Russian Interference In The 2016 Presidential Election https://www.justice.gov/storage/report.pdf

[11] Secondary market trading refers to the buying and selling of a financial instrument (e.g., Russian debt) after it has been issued.

Beyond sanctions, we must focus our efforts on winning the domestic narrative within Russia – both by exposing the corruption and criminality of Putin's regime, and through a renewed effort to bolster Ukraine as a successful, free market democracy in the near-abroad.

- Transparency outside of Russia: Treasury and other authorities should conduct a study that attempts to identify the financial intermediaries that manage and benefit from Putin's wealth and the fortunes of his fellow Kremlin kleptocrats. Even in the unlikely scenario that this effort has no effect on Putin's geopolitical calculus, it will signal to the Russian people that our quarrel is not with them, and it would provide a measure of transparency on Putin's fortunes held abroad. Passage of beneficial ownership legislation by Congress would also help to shine a light on stashes of stolen wealth held in high-end U.S. real estate, shell companies, and other anonymous investments. These efforts are long overdue.

- Transparency within Russia: Relatedly, I would encourage a robust campaign to improve transparency within Russia. Distributing verifiable evidence of corruption, and the dependence of the current regime on kleptocracy, would help to counter the government's disinformation campaign and its control of the media. Putin is ripping off the Russian people, and they deserve to know it.

- Ukraine as the positive alternative: Lastly, a comprehensive effort to counter Russian aggression requires an offensive economic strategy in its near abroad, especially in Ukraine. It remains the poorest country in Europe on a per capita income basis, largely because the reform effort has stalled. Capital continues to flow out of the country, and lending conditions are choked by interest rates in the mid-teens and nonperforming loans near fifty percent. Corruption remains rampant in the financial system and the judiciary system. The most impactful step that could be taken is conditions-based bilateral U.S. support to reinforce long-standing IMF priorities to battle corruption, improve the rule of law, and establish property rights. The overarching purpose must be to create a successful alternative to Putinism in Russia's near-abroad, a scenario that has long been Putin's worst nightmare.