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Some Russia sanctions ahead, but West has big toolkit

SIGNIFICANCE

At present, both the US and Europe – acting either as the European Union or through the initiative of single governments – are unlikely to ramp up sanctions beyond extending their current lists of Russian entities and individuals subject to travel bans and asset freezes. The West, however, has a vast array of sectoral and financial measures it can use to hurt Russia to varying degrees should Moscow further destabilize Eastern Europe.

IMPACTS

Business

Investors and companies with Russian business should formulate contingency plans for various stages of sanctions escalation.

Political

The EU faces hurdles in stepping up sanctions, both in terms of opposition from some member nations and of possible legal challenges.

Social

Sanctions against selected Russian entities and individuals and the threat of sectoral sanctions have already hit Russian FDI.

FULL BRIEFING

The limited sanctions embraced by the United States and Europe last month are already squeezing Russia.

Barring a seriously destabilizing move by Russia - such as an invasion and occupation of eastern Ukraine - the US, the European Union, and single European governments will steer clear of targeting entire Russian industries or imposing financial sanctions that could cripple the Russian economy.

However, the US and Europe are already inflicting significant pain on Russia just by threatening to resort to more serious sanctions. In addition, both Brussels and Washington are likely to further expand the list of Russian individuals targeted by the current visa bans and asset freezes, which are having palpable long-term impacts onRussia's investment climate.

Early-stage sanctions

"The sanctions [currently] in place are early-stage sanctions targeted at individuals," says David McCluskey, a lawyer specializing in business crime at London-based firm Peters & Peters.

Though Europe and Washington will be loathe to formally accept the annexation of Crimea, more serious sanctions against Russia will be wielded not in order to push Moscow to return the peninsula to Ukraine, but to keep the Russian Federation from further intervening militarily in Eastern Europe.

For the time being, existing US designations against Russian and Ukrainian officials and businessmen will stay in place, with a few more additions likely on the horizon, Erich Ferrari, a Washington-based lawyer who specializes in sanctions-related matters, tells Monitor Global Outlook. Europe's potential sanctions list could include up to 100 people, though Europe-based criminal lawyers say the final number of designations will likely be smaller.

Even that minimal degree of sanctions escalation, though, could be tricky to implement for Brussels, analysts tell MGO. "If the European Council expands the lists more broadly to include those not so closely associated with the current situation, there are more likely to be grounds for challenge in the European Court," says Catherine Fischl, who specializes in EU sanctions law at Peters & Peters in London. "There are 33 [people on the list] at the moment. The more expansive they go, the more difficult it will be to keep those people on the list if confronted with a legal challenge."

On the US side, compliance will remain limited to US-based firms and businesses. Secondary sanctions - in which the US would penalize any third-country companies that do business with Russian entities or individuals targeted by sanctions - have so far stayed off the table.

In addition to the current visa bans and asset freezes, the US State Department announced on March 27 a block on all US exports of defense equipment and related services to Russia, while the US Department of Commerce said (http://thecable.foreignpolicy.com/posts/2014/03/26/exclusive_us_quietly_imposes_new_russia_sanctions) it would temporarily halt permit approvals for "dual-use (http://www.bis.doc.gov/index.php/forms-documents/doc_view/866-bis-annual-report-to-congress-for-fiscal-year-2013)" exports, much of which are used in Russia's oil and gas sectors. Any permits not granted by March 1 have been temporarily suspended. Analysts with knowledge of the decision tell MGO they expect license approvals to be resumed if and when a diplomatic rapprochement with Russia is reached.

Prior to the US announcements, the United Kingdom had suspended a number of export licenses to Russia's military - including cloth for uniforms. Dual-use exports have also been frozen. Other European countries, however, have yet to follow suit. "Export controls are national rather than EU measures," says Maya Lester (http://www.brickcourt.co.uk/people/profile/maya-lester), a London-based lawyer who runs a blog (http://europeansanctions.com/) on European sanctions.

"The EU learned a lot of lessons on sanctions in the last few years, and their sophistication has increased. The US will find ways to ratchet up pressure," Mr. Ferrari tells MGO. "The larger point is that this is a slow burn. Targeting large individuals is going to impact them long-term by adding a degree of risk to Russia. That risk plays into assessments by US and foreign firms. They are not chopping their heads off: they're putting their heads in a vice."

Sectoral sanctions

Washington and Brussels have also threatened sectoral sanctions, should Russia continue to escalate.

"Russian military intervention in eastern Ukraine ... would likely spur substantially expanded sanctions from both the US and EU to cover metals, mining, and energy," says Alisa Lockwood, head of analysis for Europe and the Commonwealth of Independent States at IHS Country Risk.

For wholesale sanctions on sectors such as energy, automotives, and manufacturing - where Germany, France, the US, and Japan have extensive investments in Russia - cooperation among allies would be crucial, says Ferrari.

Should Washington decide to embrace whole sanctions unilaterally, it will initially zero in on sectors where the US offers products or services that other countries do not, so as to shelter allies that do big business with Russia in other areas. The US is currently Russia's largest source of foreign direct investment and, according to a 2013 report (http://www.ey.com/Publication/vwLUAssets/2013-Russia-attractiveness-survey-Eng/$FILE/2013-Russia-attractiveness-survey-Eng.pdf) by EY, formerly known as Ernst & Young, American activity in Russia has largely focused on facilitating financial services for businesses and financial institutions, as well as software and technology.

Such heavy-handed options, however, would disrupt the Russian economy, with possible serious spillovers for global growth as well. The intermediate step, to which Washington and Brussels have already resorted to some degree, is simply dangling the prospect of trade and sectoral measures before Russia, writes Christopher Weafer of Moscow-based consulting firm Macro-Advisory (http://macro-advisory.com/about.html). "The threat will be enough to delay forward investment and force both companies and individuals to take defensive positions, and that will slow normal economic activity," he noted in a special report. "No matter what happens next, it does seem as if Russia has lost 2014 in terms of its ambition to grow [foreign] investment spending."

Financial sanctions

Financial sanctions are a third option at the US and Europe's disposal, one that allows for varying degrees of escalation.

To date, Russia's Bank Rossiya, sanctioned by the US Treasury for its reportedly close affiliation with Russian president Vladimir Putin, has been effectively barred from operating in any US dollar-based transactions. On March 28, the bank announced it would shift to only ruble-based business.

The US could further restrain Moscow's trade in US dollars - including that conducted with non-American entities - by halting so-called "U-turn" transactions that must be routed through US banks for completion. For such transactions, US banks clear payments routed for a Russian client outside Russia by non-Russian financial institutions. The payment is processed through the US and instantly turned back as dollars.

At the end of the spectrum in terms of financial sanctions escalation, the US and the EU could, as in the case of Iran, blacklist notable Russian banks, including the Central Bank of Russia, and threaten penalties against the board and directors of the Belgium-based Society for Worldwide Interbank Financial Telecommunication (SWIFT) if they do not cut ties with Moscow.

SWIFT, a private financial clearing and communication system, is used by banks worldwide to send and receive payment information for financial transactions and money transfers.

With a ban from SWIFT, Russia could, in theory, keep selling its oil and gas but wouldn't be able to access the bulk of its energy revenues, says Hossein Askari, an economist at George Washington University who has authored numerous studies on the impact of sanctions.

Like sectoral sanctions, however, the most severe financial sanctions would have important spillover effects and remain off the table for now. The political cost the US would have to bear in order to enforce global compliance with a severe, unilateral financial sanctions regime - particularly among businesses and financial institutions in allied countries, like the UK, that do big business with Russia - makes it a weapon Washington is willing to wield only as a last resort.

"Sanctions inflicted damage against Iran because the US was willing to use extraterritoriality and impose fines ... to get compliance," Mr. Askari tells MGO. "All of these measures entail the willingness [by the US and EU] to pay a price. And as you ratchet them up, the costs become higher."