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Russia Tried to Isolate Itself, but Financial Ties Called Its Bluff

Even countries with limited trade relationships are intertwined in capital markets in today's world. Could the Russia sanctions change that?


By Patricia Cohen and Jeanna Smialek

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The United States, Europe and their allies are not launching missiles or sending troops to push back against Russia's invasion of Ukraine, so they have weaponized the most powerful nonmilitary tool they have available: the global financial system.

Over the past few days, they have frozen hundreds of billions of dollars of Russian assets that are held by their own financial institutions; removed Russian banks from SWIFT, the messaging system that enables international payments; and made many types of foreign investment in the country exceedingly difficult, if not impossible.

The impact of this brand of supercharged economic warfare was immediate. By Thursday, the value of the Russian ruble had reached a record low, despite efforts by the Bank of Russia to prop up its value. Trading on the Moscow stock market was suspended for a fourth day, and financial behemoths stumbled. Sberbank, Russia's largest lender, was forced to close its European subsidiaries after running out of cash. At one point, its shares on the London Stock Exchange dropped to a single penny.

There's more to come. Inflation, which is already high in Russia, is likely to accelerate along with shortages, especially of imported goods like cars, cellphones, laptops and packaged medicines. Companies around the world are pulling investments and operations out of Russia.

The sanctions "are severe enough to dismantle Russia's economy and financial system, something we have never seen in history," Carl B. Weinberg, chief economist at High Frequency Economics, wrote this week.

Russia had been working to "sanction proof" itself in recent years by further paring down its financial ties to the West, including reducing its dependence on the U.S. dollar and other common reserve currencies. It built a fat reservoir of foreign exchange reserves as a bulwark against hard times, trying to protect the value of its currency. It also shifted its holdings sharply away from

French, American and German assets and toward Chinese and Japanese ones, as well as toward gold. Its banks, too, tried to “reduce the exposure to risks related to a loss of U.S. dollar access,” the Institute of International Finance said in a February report.

But the disaster now rippling through the nation’s banks, markets and streets is evidence that autonomy is a myth in a modern globalized world.

The United Nations recognizes roughly 180 currencies, but “the reality is most global payments are still intermediated through a Western currency-dominated financial system,” said Eswar Prasad, a professor of international trade policy at Cornell University.

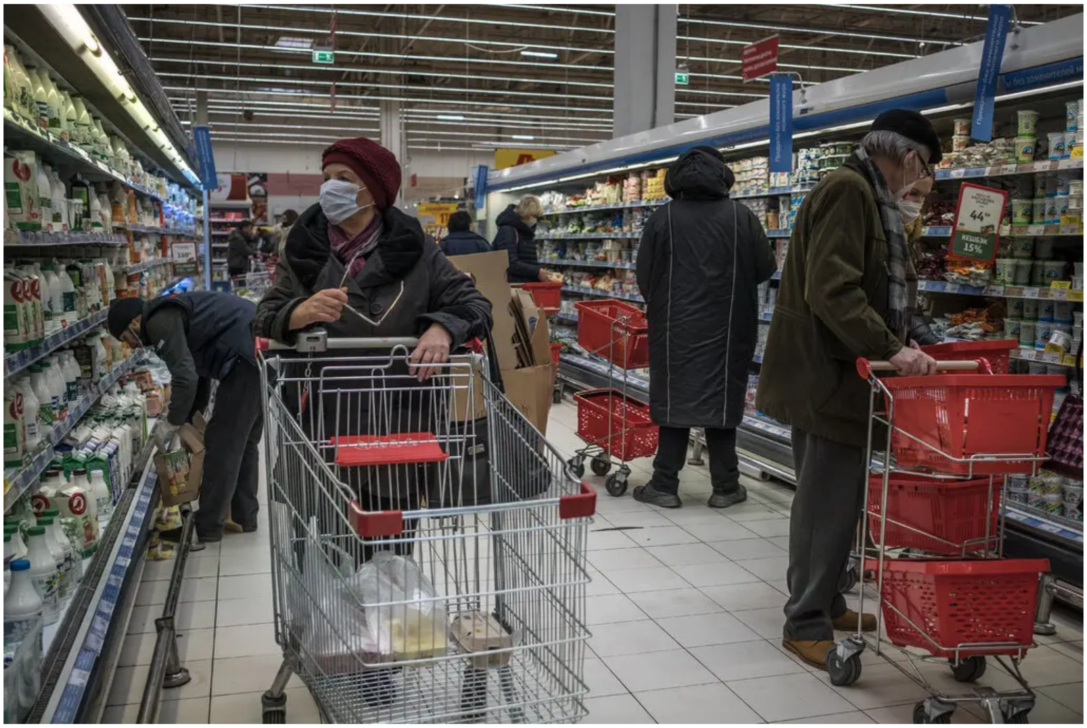
Most of global commerce is carried out in dollars and euros, making it hard for Russia to avoid the currencies. And as much as half of the $643 billion in foreign exchange reserves owned by the Russian central bank is under the digital thumb of central and commercial banks in the United States, Europe and their allies.

“They control the wealth of the world,” even the parts that they don’t own, said Michael S. Bernstam, a research fellow at the Hoover Institution at Stanford University.

While there has been speculation that Russia could mute the fallout of the sanctions by using its gold reserves, turning to Chinese yuan or transacting in cryptocurrency, so far those alternatives seem unlikely to be enough to forestall financial pain.

“When the world’s biggest economies and deepest and most liquid financial markets band together and put this level of restrictions on the largest Russian banks, including the Russian central bank, it is very difficult to find a way to significantly offset large parts of that,” Janet L. Yellen, the Treasury secretary, told reporters on Wednesday. “I believe these will continue to bite.”

The sanctions may come with a longer-term cost. The West’s overwhelming control could, in the long run, encourage other nations to create alternative financial systems, perhaps by setting up their own banking networks or even backing away from reliance on the dollar to conduct international transactions.



A market in Moscow this week. Inflation, already high, is likely to accelerate from shortages created by sanctions. The New York Times

"I would liken them to very powerful antibiotics," said Benn Steil, a senior fellow at the Council on Foreign Relations. "If they're overprescribed, eventually the bacteria become resistant."

Other countries, like Iran, North Korea and Venezuela, have experienced these sorts of financial penalties before, losing their access to SWIFT or to some of their foreign exchange reserves. But the array of restrictions has never been slapped on a country as large as Russia.

During congressional testimony this week, Jerome H. Powell, the Federal Reserve chair, was asked how easily he thought China and Russia could create an alternative service that could undermine the effectiveness of SWIFT sanctions in the future.

The Russia-Ukraine War and the Global Economy

Rising concerns. Russia's attack on Ukraine has started reverberating across the globe, adding to the stock market's woes and spooking investors. The conflict could cause dizzying spikes in prices for energy and food, and severely affect various countries and industries.

"In the near term, that's not something you could create overnight," Mr. Powell said. "It's really a question for the longer term."

That long-run trend away from SWIFT may occur in any case, some economists said. China has already set up an alternative system, which Mr. Powell noted. In the future, the current network may be overtaken by new messaging systems and financial technology.

The dollar's towering dominance in financial markets is of a different order. Over the years, economic officials have warned that such concentrated power sets up an unstable global order. And the more investment capital that zips around the globe, the more financial leverage the United States' currency has.

There are other global reserve currencies, including the euro and the yen. But a ready alternative to dollar dominance has been hard to find, especially among countries that Russia works closely with.

"China's a long way away from being ready to fulfill that," said Adam Posen, president of the Peterson Institute for International Economics.

In some ways, Russia's effort to break free from the dollar shows just how hard it is to get away from the world's dominant currency.

Nearly half the country's external debt is still in dollars, and households and companies continue to hold dollars, the Institute of International Finance pointed out. And while Russia and Europe have looked to settle trade between them in euros, the nation's major export is oil — which tends to be settled in dollars.

"I think in the longer term, certainly U.S. rivals such as China and Russia will try to find workarounds," Mr. Prasad, the Cornell professor, said. But "this cannot change on the dime."

Russia's vulnerability to financial sanctions may be a sign that its policy of economic isolation — notably its limiting of trade ties — has backfired, Mr. Posen of the Peterson Institute said. Had Russia been more integrated in the broader trade system, inducing a financial crisis by applying sanctions would have been more costly to its Western trading partners, making this form of punishment a less attractive diplomatic tool.

"This illustrates the opposite of what the Russians have been thinking," Mr. Posen said. "You're less vulnerable to being cut off in an aggressive way if you are more integrated."

Ana Swanson contributed reporting.