

Rory Macfarquhar
What Happens Next – 03.20.2022

Rory MacFarquhar:

Larry, you asked me to talk about the unexpected effectiveness of the West sanctions response to Russia's invasion of Ukraine. In contrast, you were implying to our response of the annexation of Crimea in 2014-2015, when I was involved in designing the sanctions in the U.S. government.

First point to make about sanctions as a tool of foreign policy is that they should be prospective, aiming to change behavior in the future, rather than just a way of punishing bad behavior that's already happening. To be credible, the country has to follow through on these threats.

Biden, long before the invasion began, made clear that the United States was not going to get into a direct shooting war with Russia over Ukraine, he had to issue loud threats about the costs that the United States would impose on Russia if it were to invade. When the invasion began, the United States and other G7 countries acted very swiftly.

The contrasts between this time and 2014-2015, back then, we tried to make distinctions among Russians, those who were Putin's friends and allies, and those who were not. Distinctions even among the oligarchs. Our stated goal was not to hurt Russia, or the Russian people, or the Russian economy, but to target Putin's friends and allies, the so-called cronies among the oligarchs who owed their wealth entirely to their relationship with Putin.

Similarly, we targeted the state-owned enterprises and institutions that were the pillars of the Putin regime but did not go after private companies or the Russian economy as a whole.

A second factor that acted as a constraint in 2014-2015 was that we wanted to move as closely as possible in lockstep with the EU. This wasn't just because of the political symbolism of trans-Atlantic unity. More importantly, trade and investment flows are simply much greater between Europe and Russia than between the United States and Russia. So, coordinated sanctions had much more of an impact on Russia.

The EU had a lot of economic sensitivities for that very reason. Most obviously, anything that could affect the flow of oil and gas, and we took great pains to accommodate Europe's red lines to remain coordinated.

This time it's different. First of all, the magnitude of Russia's transgression has been infinitely greater. Second, Ukraine is run by a government that commands much more international sympathy than its predecessor in 2014-2015. And finally, the EU has been in the lead rather than a constraint on the imposition of sanctions.

There are a lot of explanations including the political dynamics within Europe and the specific leaders in Brussels. Another factor is arguably the EU's skepticism and all of the intelligence that the U.S. was sharing with them for the months leading up to the invasion, which put a lot of pressure on EU leaders when the invasion actually happened to catch up and respond with force.

I don't think anyone anticipated the spontaneous response by the corporate sector in the West, much of it above and beyond the legal requirements of sanctions. This reflects, in part, the rising ESG and stakeholder capitalism in recent years, and the heightened responsiveness of CEOs to pressure from a wide range of internal and external interest groups.

This time, the sanctions have not sought to target bad guys in Russia. They're targeting the Russian economy writ large. Everyone in Russia is being treated as an accomplice in Putin's invasion of Ukraine. There's not been any effort to drive divisions within the Russian elite. No perhaps naïve belief that anyone is going to go to Putin and beg him to stop the war because they've lost some money.

Instead, the goal is to weaken Russia, to reduce the revenue available to wage war, to force Putin to expend time and resources on domestic repression and economic support rather than on foreign adventurism.

So far, the sanctions have not stopped Putin's armies, but there's no question that Russia is feeling these costs, and that they will be a factor in how long this war continues.

Larry Bernstein:

Thanks Rory, the Russians assumed that the West would enact sanctions after a Ukrainian invasion, but that did not deter Putin.

Rory MacFarquhar:

I don't think that the Russians did anticipate the magnitude of the sanctions. They underestimated the sanctions that were coming in 2014-2015 based on what they saw in 2008 and the very rapid move to forgive Russia after the invasion of Georgia. And, we did more than they expected.

But, this time around, they seem to have been assuming that we would do something incrementally more than we did in 2014-2015. I think there was no understanding about how rapidly both the U.S. and EU would move all the way to the far end of the sanctions spectrum and do quite extreme measures, such as sanctioning the central bank, removing Russian state-owned banks from the SWIFT messaging system.

We did to Russia in the space of a week or two what it took us decades to do to Iraq. I don't think that the Russians anticipated that at all.

Larry Bernstein:

I suspect during the peace negotiations; Putin will demand the removal of the US and EU sanctions. If we agree, what have we accomplished?

Rory MacFarquhar:

That's a very good and important question, and the reality of U.S. sanctions programs is that they tend to last a very long time. And, political coalitions develop behind them, and it's a lot easier to put sanctions on than to remove them.

Will the U.S. and the EU be willing to include sanctions relief as part of a negotiation? I think the answer is yes. But Russia is going to have to offer up something pretty significant in return, and there's a real question mark as to whether Russia is going to do that.

Is Russia going to give Ukraine credible security guarantees, compensate Ukraine for the damage that's been done, give back territory that it seized? I don't think it's going to do any of those things, then it's looking at having these sanctions in place indefinitely.

The sanctions that were put in place in 2014-2015 were connected to the annexation of Crimea and the war that was started in Donetsk and Luhansk, those were never removed because the cause of those sanctions was never removed. That's what we're going to see this time.

Larry Bernstein:

The 2014 Crimean sanctions were limited to Putin's cronies, why did the sanctions expand to the entire Russian population this time?

Rory MacFarquhar:

On the moral level, the international community has made the implicit decision that all Russians bear responsibility for Putin.

Ultimately, if they want these sanctions removed, they're going to have to take their complaints to the top. Those innocent Russians are dutifully showing up in polls every six years and voting for Putin. They are beneficiaries of that system, and they will be accountable.

The pragmatic level, if in 2014-2015, in naïve moments, we may have thought that Putin's buddies would go to him and say, "Enough, enough already. This is actually hurting." Clearly, no one among Putin's friends was willing to say a word against his foreign policy.

So, now, they're testing the proposition, Putin's enemies will do that. Maybe people who don't like Putin will organize against him.

Larry Bernstein:

Economic sanctions are as old as time. Very often, the worst hit are the poor and children who will not get enough food. Why is this a moral solution?

Rory MacFarquhar:

I don't think that the Russian people are going to starve. I do worry about other people around the world starving as a result of this conflict, because Russia and Ukraine together are two of the largest grain exporters in the world.

Having both countries exports disrupted will certainly lead to higher food prices and hardship across the developing world. But Russians aren't going to starve. It's an upper middle-income country, and it's going to suffer a significant drop in the GDP.

It's going to be a huge long-term disappointment. It's suffering a huge brain drain. A lot of liberal Russians are trying to get out.

Larry Bernstein:

One of the major political objectives of American foreign policy is to increase global trade, build international institutions like the WTO and create free trade zones. Kicking Russia out of the WTO, undermining existing long-term commercial contracts with Russian firms, and terminating investments in Russia will undermine these trade goals in Russia and in many other countries.

Rory MacFarquhar:

Globalization is not actually that old. The Soviet bloc trading system was 30 years ago. Globalization and peace are really two sides of the same coin. And if you get into a situation of significant geo-political tension, rivalry, even war, it's ridiculously naïve to expect that you can enjoy the same level of seamless global trade flows that you did at times of peace.

When the shooting starts, goods don't move. I don't think that it's going to be sustainable long-term to be buying oil and gas from Putin. It would be great to have seamless global trade, but that's just not going to be possible the way Russian is current acting.

The U.S. clearly has very strong interests in the centrality of the dollar and U.S. treasuries to global finance. When the United States takes the step with the Russian Central Bank declaring that hundreds of billions worth of risk-free assets are suddenly not so risk-free from the perspective of the central bank. The entire approach to macro-economic management adopted by the developing world of the last 30 years is at heightened risk of instantaneous nullification by the authorities of the United States and the European Union.

That is going to have huge reverberations for the way macro-economics and global finance takes place. And we still don't even have an understanding of how that plays out.

Larry Bernstein:

What happened to the Russian Central Bank? Did we expropriate their Treasuries?

Rory MacFarquhar:

We may literally have done that. We'll see whether the Russian Central Bank ever gets them. You'll recall how much pain the Obama administration went through in domestic political terms when it tried to give Iran some of its money 30 years later.

Larry Bernstein:

Oh yea, that big plane that we flew to Iran with all that cash?

Rory MacFarquhar:

(laughs) So, it's not so easy to give money back once you've taken it.

Larry Bernstein:

As a technical matter, what did we say?

Rory MacFarquhar:

It's pretty ambiguous whether these reserves are frozen or whether we're simply blocking transactions involving them.

Different people have said both. And, this is clearly the part that the Russians will want to negotiate for, because not having access to 400 billion dollars of their own money is something that is pretty difficult for them.

Whether this is a wise long-term U.S. policy comes down to a recognition that a lot of the principles that governed a peaceful world simply do not hold. No reserve manager in a close ally of the United States is going to lose any sleep over the security of its U.S. Treasury holdings. But for countries that are either in a state of conflict with the United States, or in a potential state of conflict, I think it's going to be a lot of hard thinking about how they can manage their macroeconomy without that kind of dependency.

Larry Bernstein:

China has more than a trillion dollars of US Treasuries and China's foreign policy will be in conflict with the US at some point in the future. Does this mean that the Chinese should move its G-7 Government bond reserves to other assets like corporate bonds?

Rory MacFarquhar:

It doesn't matter whether Treasury, agencies, or corporates, or if they're in Euros either. None of this stuff is potentially safe, none of it. Where on earth is China going to put three trillion dollars. Answer is nowhere.

They have to come up with an entirely different macroeconomic management strategy. It wouldn't be seamless. If I were them, I'd probably be starting to do it tomorrow.

Larry Bernstein:

America has enjoyed enormous benefits from being the world's reserve currency and having foreign central banks like Russia and China buy trillions of our Treasury debt, why would we want this to end?

Rory MacFarquhar:

In a more conflictual world, where we are decoupling in trade, contemplating kinetic conflict over Taiwan, it's just not imaginable that we compartmentalize our financial relationship, to continue to have our central bankers attending black-tie dinners with one another as our military flying sorties at each other.

Larry Bernstein:

Many global multinational corporations have announced that they will discontinue operating in Russia. Do we want private firms engaging in foreign policy? Will they have a seat at the negotiating table?

Rory MacFarquhar:

(laughs)

These companies are responding to a whole host of external and internal pressures from companies' own employees.

There's a symbolism to McDonald's presence in Russia. It came to the Soviet Union in the late '80s. It was one of the first big visible U.S. investments in Russian retail sector. It was a sign for Russians that Russia would become normal. And so the disappearance of McDonald's is exactly the reversal of that symbolism.

The rise of ESG in the United States was fueled in large part by the perception that government was failing to respond to clear needs in areas like climate change.

Larry Bernstein:

What is your best guess how this Ukraine war will play itself out?

Rory MacFarquhar:

I'm no military analyst. I am just a newspaper reader like anyone else. I look at the basic disparities in the strength of the two sides in Ukraine and my strong suspicion is that no matter how much hardware is supplied to the Ukrainians, no matter how many foreign fighters volunteer to join the Ukrainian side, it's a matter of time before Putin does so much damage to that country that ultimately, he defeats it.

Larry Bernstein:

Rory, I end each episode on a note of optimism. Find some optimism in that.

Rory MacFarquhar:

(laughs) Look, this Ukrainian president, Ukrainian people have been an inspiration to all of us, to the West, to our values. They have galvanized NATO in a way that has brought it back from a period of, of existential crisis. And I think that we are probably in a better position now as an international community to face up to the next threat, whether it comes from Putin or from Xi Jinping.

Larry Bernstein:

Rory, what will it take for Biden to make a military response?

Rory MacFarquhar:

It would take something pretty extraordinary for that to happen, such as Putin using a tactical nuclear weapon. I can't see Biden changing his mind on putting US troops in harm's way to defend Ukraine short of that.

Larry Bernstein:

Thanks Rory.