Testimony of the Honorable Clay Lowery
Senate Committee on Banking, Housing and Urban Affairs on

"Advancing National Security and Foreign Policy Through Sanctions, Export Controls, and Other Economic Tools"
February 28, 2023

Chairman Brown, Ranking Member Scott, and Members of the Committee, I would like to thank you for the opportunity to testify on Advancing National Security and Foreign Policy through Sanctions, Export Controls, and other Economic Tools.

My name is Clay Lowery, and I am currently Executive Vice President of the Institute of International Finance (IIF), a trade association that represents 400 financial services firms in roughly 65 countries across the globe. My testimony today is not on behalf of IIF or any of its members and should be considered my own views.

I served in the U.S. Government from 1994 to 2009, principally with the Treasury Department, although I also was the Director of International Finance at the National Security Council. From 2005 to 2009, I served as the Assistant Secretary of International Affairs for the Treasury Department, and one of my primary responsibilities was overseeing the Committee on Foreign Investment in the United States (CFIUS).

I am pleased to be testifying alongside Kevin Wolf and Daleep Singh, both of whom I respect deeply and of whose views and expertise I think highly.

In my testimony, and as requested by the Committee, I will discuss briefly:

(i) the economic impact on Russia due to the sanctions regime put in place in 2022,
(ii) some of the lessons that can be drawn for thinking about China, and
(iii) the idea of an outward-bound investment screening mechanism using the prism of CFIUS.

Sanctions on Russia

A year ago, Russia invaded Ukraine. In response, the United States, along with a number of allies, imposed a set of financial sanctions, export controls, and a myriad of other measures to both punish Russia and to influence its decision-making. It is arguably the most robust financial sanctions package in history: unprecedented in terms of the size of the economy being sanctioned, the comprehensiveness of the sanctions regime, the multilateral cooperation and implementation, and the speed in which the program had been put in place.

A year later, this has had a substantial economic and financial impact on Russia, but it has neither been as dramatic nor as sweeping as was estimated last year. While early forecasts – including by my own organization – suggested Russia's real GDP would fall by 8 to 15 percent of GDP in 2022, it instead contracted by 2 to 3 percent of GDP.

Why is this the case?

There are a number of factors that have allowed Russia to overcome the most dramatic impact of these sanctions:

- **Expansiveness:** Although the sanctions regime was expansive, there are still major carve-outs most clearly seen in what was not sanctioned: Russia's major exports – natural gas, oil, and petroleum products. With the rise of prices in those markets and some increase in volumes, it still led to Russia's current account surplus nearly doubling in 2022, which means an extra $100 billion. As an example, just looking at oil exports, my colleague Elina Ribakova, estimates that price differentials accounted for over 85% of Russia's oil export revenue growth from 2021 to 2022.

  A significant percentage of the Russian banking system, including the central bank, had their assets frozen, lost access to dollar and euro funding, and eight Russian banks have been removed from the SWIFT messaging system. However, the Russian state – particularly the central bank – adjusted, and assets were diverted to other parts of the financial system that were not sanctioned.

  In short, a current account surplus provided much-needed liquidity to Russia's economy, even though its central bank assets had been frozen. Just as importantly, it also provided revenue to prop up Russia's fiscal position.

- **Multilateral Coordination:** The Biden administration quickly and successfully put together a multilateral coalition for both sanctions and export controls – impressive, considering that many of these countries' economies are quite dependent on Russian energy. That said, this coordination has neither been consistent enough nor broad enough.

  This can take a number of forms but for brevity, the two most common are the less well-known issues of jurisdictional disparities among sanctions regimes across the world that lead toward deleterious consequences for compliance, and the more prominent issue of significant jurisdictions simply not joining the "coalition".

  Addressing the first issue continues to evolve and the G-7 has focused on improving consistency, which should help with sanctions avoidance. Whereas the second problem is the area that shows up in the numbers.

  For example, Russian oil export volumes fell across the EU, Japan, Korea, and several other countries. Yet, Russian oil export volumes overall were still up in 2022, as countries such as China, India, and Turkey increased their purchases by enough to make up for these volume losses – and, of course, this does not count my earlier point about price effects.

- **Adaptability:** The 2022 sanctions package was an extensive expansion of the sanctions package against Russia that has been in place since the 2014 annexation of Crimea. During that time, Russia had built up what has been called "Fortress Russia" -- measures to insulate its economy from Western sanctions.

  In addition, the Central Bank of Russia took swift and decisive measures – providing liquidity, doubling its interest rates, putting in place capital controls, and forcing foreign currency deposits to be converted to rubles – that allowed the exchange rate and the banking system to stabilize. And as this stability was realized, a number of these measures were removed.

Russia's economic and financial resilience in the face of such a major sanctions program does not mean that the program was a failure. In fact, it seems to be having an impact on Russia's ability to obtain war-fighting materials, has led to a "brain drain" of skilled Russian workers, and is likely to lead to a slow but steady decrease in productivity and economic activity for years to come.

Lessons Learned

Although it is early, the lessons that can be drawn from the results of the latest Russian sanctions regime are important. And in the context of China, as you have asked me to consider today, they are even more stark.

The key difference, of course, between China and Russia is China's economy and overall engagement in the world economy is simply magnitudes bigger than Russia's in both scope and scale. To an extent, we are comparing an apple to an orange.

- China's GDP is 10 times larger than Russia's;
- China exports are roughly 7 times greater than Russia's and its imports are almost 9 times greater;
- China's Foreign Direct Investment (FDI) stock is about 6 times greater than Russia, while Its outward-bound investment stock is 5 times the size of Russia's;
- While Russia is a global exporter of natural resources, China has a much more diverse economy, and is much more interconnected with the U.S., and most other economies;
- China's commercial banking sector is many times greater than the assets of Russia's banking system and its domestic bond market is much, much larger; and.
- Many of the sanctions that were implemented on Russia in 2022 were extensions of earlier sanctions imposed in 2014 – meaning that the U.S. private sector's engagement and investment in the country was already limited. That is not the case in China.

However, I think we can still draw three key insights from Russia as they relate to China:

1. **China – like Russia – has a significant current account surplus**, but instead of being a major commodity exporter, they are the top exporter of manufactured goods. In the last year, the importance of Russia to energy and commodity markets has been clear. Researchers at the Center for Strategic and International Studies estimate that China's share of manufactured exports are more than twice the share of Russia's share of Russia's energy and fuel exports.[1] Again, a current account surplus is a major reason Russia was able to overcome the most dramatic impact of Western sanctions.

2. **International coordination may be more difficult as it relates to China.** Throughout the war between Russia and Ukraine, we have seen unprecedented cooperation across the G-7 countries and beyond. Where there is common cause among countries to use such tools, it is vital that the official sector is internationally coordinated and coherent, and that certain elements are harmonized across regimes. That said, the design and implementation of sanctions may always elicit differences dependent on wider geopolitical considerations. Each country naturally considers its own interests when participating in a sanctions regime. And while many jurisdictions have been highly motivated to implement sanctions on Russia, we have often seen that it has been a struggle. China's much broader and deeper engagement in the international economic system suggests that this struggle will be much greater and that the motivation to implement sanctions is likely to be weaker.

3. This brings me to a third point, which is **implementation risk**. Even if international coordination is high, sanctions regimes are always complex, and executing them is not like flipping a switch. At the IIF, we have heard from financial services firms across the globe who have been diligently working to understand and properly implement the sanctions regime. From that, we have noticed that there should be a clear focus by authorities on international alignment for such things as prohibitions/lists of sanctioned individuals, sectoral application, and the timing of designations across jurisdictions, alongside coordinated communication on guidance concerning sanctions on a cross-border basis. This should be coupled with discussions on how financial crime risk management efforts can be deployed effectively to mitigate the circumvention of sanctions - including, *inter alia*, beneficial ownership transparency, public/private sector information exchange, and the deployment of standards for non-financial businesses and professions.

The bottom line is that sanctions regimes are difficult to implement, multilateral cooperation is complicated – particularly for larger economies, and you can't plug every leak. We also know China's capability to retaliate economically is significantly greater than Russia's.

CFIUS and Outward-bound investment

[1] Gerard DiPippo and Andrea Leonard Palazzi, "Bearing the Brunt: The Impact of the Sanctions on Russia's Economy and Lessons for the Use of Sanctions on China", CSIS, February 2023.

One of the tools that the Administration and Congress has been considering to influence our economic relationship with China is an outward-bound investment screening mechanism. Some have called it a “Reverse CFIUS”. As an individual who oversaw CFIUS for a time in my career, I thought I’d try to suggest lessons that could be learned as this Congress thinks through it.

The most important thing to understand about CFIUS is its objective: ensuring national security while promoting foreign investment. From a policy perspective, this meant to me that legislation, operations, and implementation should:

> (i) minimize the opportunity for politicizing transactions,
> (ii) keep CFIUS narrowly focused on national security and resist the impulse to use it for broader economic policy goals, and
> (iii) ensure accountability of the executive branch for protecting national security while welcoming foreign investment.

I realize that there have been numerous attempts to design legislation for an outward-bound investment mechanism in the past few years and that the Administration is considering an Executive Order to create a system. It is not my place – at this time – to make a judgment on any specific proposal, but besides the policy goals I note above for CFIUS – I think there are a few other lessons that could be drawn as either legislation or executive branch action is considered:

> (i) avoid the temptation to use vague and ill-defined terms;
> (ii) don’t duplicate existing authorities in an agency or committee with little experience or expertise;
> (iii) understand that there is a resource burden on the executive branch that makes implementation difficult; and maybe most importantly
> (iv) realize that placing such government controls on private-sector transactions – particularly in cases that have nothing to do with national security – is likely to harm our competitiveness and may prove to be counterproductive to our national security.

Conclusion

Thank you again for the opportunity to testify today. I stand ready to serve as a resource to the Committee on important issues related to economic sanctions and cross-border investment restrictions, and I’d be pleased to take any of your questions.