Statement by Daleep Singh

Hearing on Countering Russia: Assessing New Tools

Committee on Banking, Housing, and Urban Affairs

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Mr. Chairman and Ranking Member Brown, 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. Looking back, I draw three main conclusions from the experience: (1) sanctions "do their job" if they are carefully designed and embedded into a coherent foreign policy; (2) the signaling of future sanctions is at least as potent as the actions themselves (like any weapon, the best sanctions are never used); and (3) sanctions aren't enough to change behavior. Bearing these lessons in mind, I will offer suggestions to counter ongoing Russian aggression and malign behavior – both using sanctions and other economic tools.

For context, allow me to share perspective from the 2014 experience.

<u>How were sanctions designed in 2014?</u>

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 clear: design a menu of options that could deliver[1] economic costs while minimizing spillovers to the U.S. and global economy.

We pursued this objective by first writing down a set of guiding principles that remain instructive. 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 costs; (2) responsible to limit contagion through the U.S. and global financial system; (3) targeted to avoid the appearance of punishing the Russian civilian population and, in doing so, strengthening Putin's domestic narrative; (4) calibrated to increase the chance of partnering with European and international allies;

[1] Strictly speaking, maximizing costs (financial crisis) was not the objective.

and (5) staged to preserve scope for escalation or de-escalation, in addition to learning from previous steps.

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 vulnerability? Foreign capital was and is an obvious choice. U.S. and European firms are the dominant suppliers of something Russia needed in large quantity and could not easily replace from other sources. Similarly, in energy, Russia's supply chains were dependent upon U.S. and European technology to boost their long-term production capacity and innovative potential. Here again, U.S. and EU companies are major suppliers of goods and services that Russia needs and cannot easily replace.

Financing restrictions proved especially potent

Restricting foreign capital proved even more potent than we anticipated. By removing 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 wave of capital outflows from Russia, followed by economic recession.

The mechanism by which the financial restrictions operated is worth recalling to appreciate their potency. For sanctioned entities, the restricted supply of Western capital spiked their cost of borrowing and reduced their access to foreign capital at any price. The sudden financing shock impaired our targets' credit profiles, leading to record levels of capital outflows from Russia as a whole. In a futile attempt to defend the ruble, the Russian central bank depleted about a quarter of its foreign currency reserves before allowing the currency to depreciate up to fifty percent from its pre-sanctions level against the U.S. dollar. Importantly, the speed of the negative feedback loop in Russia was determined by market forces and Putin's own actions, not prescribed in advance by U.S. policy.

Import prices surged in tandem with the weakened currency and pushed overall inflation to the mid-teens, forcing several rounds of emergency interest rate hikes by the central bank to extreme levels. Banks required government injections of capital and regulatory forbearance to avoid insolvency. Adjusted for inflation, wages and spending collapsed. Bank lending and investment dried up.

Spillover risks were managed carefully

By the second half of 2014, we knew these sanctions had the potential to deliver a knockout blow, particularly with lower oil prices causing a dual shock[2], but we took care to limit unwanted spillovers – both to increase the staying power of sanctions and to avoid appearances of targeting Russian civilians. Our sanctions only targeted a handful

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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 a larger role.

of state-owned companies in key sectors. We did not target private companies, nor we did not sanction all sectors of the economy. We prohibited new U.S. flows of financing to the targets of our sanctions, but existing stocks of risk were not disrupted. U.S. investors remained free to reduce exposure to Russia at a pace and magnitude of their own choosing. Derivatives and money markets, both of which tend to be the ‘dry tinder’ of financial crisis, were largely untouched by sanctions.

Impact and spillovers were largely as expected

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 2.8 percent in 2015, the largest decline among large economies, and the recession continued in 2016. Somewhere between one-half and two-thirds of this impact was likely caused by lower oil prices; the rest we can conservatively attribute to sanctions.

Over the medium term, these sanctions dealt a weak strategic hand to Putin's Russia. Its already depleted capital stock was starved of much-needed financing and direct investment. Removal of U.S. and European energy technology, and the de-integration of Russia from the global financial system, deprived Russia of key inputs to productivity growth and made its economy even more brittle. The overall chilling effect reportedly prompted defections from talented portions of Russia’s declining labor force. As of last July, the IMF estimated potential growth in Russia over the medium-term at no more than 1.5 percent.

Meanwhile, unwanted spillovers within Russia and to western economies were largely contained. Sanctions forced the Russian government to deplete a portion of its finite set of resources to contain financial and economic stress, but we avoided causing widespread panic and impoverishment among the general public. This was consistent with our purpose: to create diplomatic leverage and deal space, not to deliver a knockout blow.

Blowback to the U.S. economy was minimal in the aggregate, although certain businesses and sectors were more negatively affected. (By construction, sanctions are an economic distortion; spillovers are unavoidable). Even for Europe, where direct trade and financial linkages to Russia are far more significant, the effects were summarized by the European Commission as “contained.”[3] In fact, without sanctions, it is fair to project that the costs and uncertainties brought about by unchecked Russian aggression in the heart of Europe would have been far less contained that what was experienced.

Signals were at least as important as actions

Throughout this process, both the impact and spillovers from sanctions were managed through signaling. The signals were expressed by the most senior officials of the U.S.

[3] 0.3% of GDP in 2014 and 0.4% in 2015

government, and they were made credible by a coherent, multi-faceted, and coordinated foreign policy.

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 – a recognition that the best defense against Russian aggression was a strong economic offense. 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 replicate our sanctions after close consultations (which they did, multiplying the direct effect of sanctions and reducing the competitive disadvantage to U.S. firms). The same credible threat of escalation was repeated 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.

Many of the most punishing days in Russian markets during 2014 were not those in which new sanctions *actions* were formally announced; some of the biggest impacts were delivered after *signals* about future policy were revealed. This makes intuitive sense. Markets are forward-looking; asset prices determined by expectations about the future. Escalatory signals were often enough to could deliver impact to Russian markets without taking any new action, and they were perhaps a small counterweight to Putin's so-called "escalation dominance" in the military realm. Of course these effects become muted when investors doubt the credibility of the threat, but this has only become a relevant concern more recently.

Changing behavior

Did any of these costs ultimately matter to Putin? Answering this question is beyond my expertise, but I would observe that any leader – however rogue – cares about popularity (at least as a method of control), and recessions do not win hearts and minds. Putin's tolerance for economic pain is demonstrably higher than that of most Western leaders, but I believe there is a threshold above which his calculus is changed. Pointing out Putin's history as a tactical opportunist, some have argued convincingly that were it not for the mounting costs to the Russian economy in late 2014, Putin's forces would have marched all the way to Kyiv; or, at a minimum, he would have rejected even half-hearted engagement in the Minsk process. We'll never know the counterfactual, but by the Russian leadership's own admissions the impact of sanctions was appreciable during this period. Even less clear is whether we managed to win the narrative. Do the Russian people understand that U.S. sanctions were an attempt to defend the sovereignty and territorial integrity of a free country? Or do most Russians believe in Putin's story that the recession of 2014-15 is just the latest in a series of historical injustices perpetrated by the West? We simply don't know the answer, and this is a subject I will address in the recommendations section.

Current context and recommendations

Turning to the current context, we know that Russian aggression and violations of sovereignty have spread across Europe and the UK, into Syria, and certainly here at home. At the same time, economic and financial conditions in Russia have improved markedly. The economy is out of recession. Inflation recently touched an all-time low. Oil prices have tripled from their trough. Foreign reserves have been replenished to pre-sanctions levels. The government's deficit and debt profiles remain sound. Both the provocations from Russia, and its ability to absorb a hit from sanctions, have increased.

Against this background, I would emphasize that the sanctions toolkit designed in 2014 does not need to be reinvented. What matters, ultimately, is the political willingness to use our sanctions tools in a sustained and coherent fashion, together with high-level signaling that expresses our resolve to change Putin's behavior. Escalation can take two general forms: increasing the scope of existing sanctions to cover a broader set of targets, or deepening the scale of impact on any particular individual or institution. Sanctions can go broader, deeper, or both.

Below I sketch out an illustrative set of options that apply the principles described earlier.

1/ First, costs should be broadened to include the very highest levels of the Russian government. At a minimum, Treasury and other authorities should conduct a study that attempts to identify the location, holdings, and financial intermediaries that manage and benefit from Putin's wealth. 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 might provide a measure of transparency on his fortunes held abroad.

2/ Second, U.S. investors should be prohibited from purchasing new Russian sovereign debt. In 2014, I was more cautious about the unpredictable spillover effects that could result from a sudden disruption to Russia's risk-free, benchmark asset, particularly during a period of acute stress. To be clear, this is still a serious step -- but circumstances have changed. Russia is far better able to absorb a hit to its sovereign debt market, considering the background conditions described earlier, [4] and investors have had years to reduce exposures in Russia. More to the point, I can think of no credible argument why U.S. public pension funds and savings vehicles should indirectly

[4] In fact, the Russian Finance Ministry recently suggested it would buy back its domestic debt in an adverse scenario.

fund the Russian government while the latter continues to sponsor violations of U.S. sovereignty.

3/ Third, while I am not in favor of prohibitions on secondary market trading[5] 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 be an effective step to generate a broader chilling effect, especially if it includes a grace period. By itself, this measure would not prohibit any activities, but markets are conditioned to read the signals. These financial institutions are appendages of the Russian government, oriented around domestic lending with relatively fewer international linkages than other large Russian banks.

4/ Fourth, a comprehensive package to counter Russian aggression requires an offensive economic strategy in its near abroad, not only to Ukraine but also to Georgia, the Baltics, Moldova, and possibly central Asia. Possible steps could include conditions-based financial support to reinforce long-standing IMF priorities in the region to improve the rule of law, battle corruption, and implement market-oriented reforms. The overarching purpose is to create successful alternatives to Russian-style autocracy.

5/ Finally, I would strongly 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 campaigns and its control of the media. Working with the IMF and other multilateral institutions could also shine a light on the basic challenges of doing business in Russia – enforcing contracts, protecting intellectual property, and defending property rights. Fostering genuine private-sector exchanges between the U.S. and Russia could also help in this regard.

Mr. Chairman and Ranking Member Brown, thank you once again for the invitation to testify, and I look forward to your questions.

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