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The London School of Economics and Political Science

WEAPONISING THE GLOBAL ECONOMY

The Risks and Rewards of Sanctions, and their Role in Economic Statecraft

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In the second evidence session on the future of global economic governance, the Commission discussed how increased economic interdependencies have changed the nature of economic statecraft and global economic governance. The weaponisation of global economic networks on display during Russia's invasion of Ukraine with Ukraine's allies and partners imposing a variety of financial and economic sanctions against Russia, and Russia implementing inflationary export bans against several European countries in response—have brought to the fore the economic and geo-economic problems that accompany this new era of 'weaponised interdependence'. In light of these events, the Commission assessed how forms of economic coercion have changed, how states, firms and individuals might reposition themselves, and how this process could inflect issues of global economic governance and cooperation.

The last two decades of economic integration saw a sharp increase in demand from emerging markets. This allowed Russia, rich in natural resources, to become a major commodities exporter and an important node in an expanding global economic network. It also afforded Russia significant economic and political heft in global affairs: insulating Russia from foreign economic and non-economic pressures (e.g., providing a large foreign-exchange reserve buffer); incentivising foreign powers to pursue accommodationist policies in order to access Russian resources (e.g., the European Union via 'NordStream 2'); and raising the spectre that Russia would be able to make use of those resources in order to feed other geopolitical interests (e.g., periodically cutting off natural gas flows to Ukraine in the past two decades). The policies of Russia prior to the invasion of Ukraine reflect the grave problem inherent within these interdependencies for global economic governance. Dr. Kalyanpur outlined the ways in which the Russian government under Putin attempted to guard itself against Western economic power since the 2000s and, especially, after Russia's 2014 invasion of Ukraine. The strategies ranged from reducing import dependencies and the onshoring of production in key sectors related to the defence industry, the accumulation of large amounts of currency reserves (primarily by drawing on the foreign-exchange earnings of hydrocarbon exporters), to the simultaneous implementation of austerity policies—operating with large amounts of fiscal space—in the eight years running up to the conflict. It is clear that this attempt to 'sanction-proof' the Russian economy has largely failed, Dr. Kalyanpur noted. The economic and financial sanctions imposed by the G7 and its allies in recent months have taken a significant toll on the Russian economy. These effects are not limited to the deteriorating of Russia's foreign exchange position but extend to its ability to successfully pursue the conflict, due to the collapse of manufacturing exports from key trading partners such as South Korea and Germany.

The state response in this episode suggests a number of important questions for the future of the international economic order: what will other states do to insulate themselves from this kind of economic statecraft? Will the West's sanctions measures be feasible in the context of increased tensions between the United States and China? To what degree does the weaponisation of global economic networks undermine effective governance, such as the functioning of the global economy—for example, global financial stability—and the provision of global public goods, such as coordinating climate and development finance efforts? Moreover, what should countries and International Financial Institutions (IFIs) do to navigate the risks that the new era of 'weaponised interdependence' creates?

WEAPONISATION EVOLVING: FROM MARKET ACCESS TO NETWORK ACCESS

What does the Western response to Russian aggression imply for the role of the economic networks in global affairs? Professor Newman contended that recent events are sharply at odds with the standard narrative about the relationship between globalisation and global politics. This narrative stressed the triumph of large, private economic interests over the geopolitical prerogatives of the state. While this is not the first time that this has been shown to be a fallacy, the crisis has dealt this frame a more decisive blow. The notion that economic coercion was an alternative to war should be replaced with a recognition of how these economic networks are in fact employed as weapons of war. What the new framework has to stress is not the 'softening' effects of trade—sometimes referred to as the theory of 'doux commerce'—but the fact that increased integration into the global trading and financial system has introduced new forms of economic coercion that can be deployed in pursuit of geopolitical goals.

Professor Newman then provided an outline of how this new form of coercion takes shape. In the past, traditional sanctions regimes meant restricted market access; one state would condition another's private entities to engage in trade. What is now instead being conditioned is network access, including economic networks that states rely on to conduct international financial and trading activities, centralised in entities that are national or over which certain states have outsized control. Two prominent examples are the SWIFT messaging system used for international payments, based in Belgium, and the correspondent banking relationships at the basis of the global dollar-based clearing and settlement infrastructure, which is entirely under the jurisdiction of the State of New York.

The recent sanctions condition access to key nodes of the financial system, which undermines Russia's ability to make use of its foreign reserves to buy key goods or to prop up the value of its currency. Similarly, they condition access to the supply chains of major aeronautics manufacturers, which in turn make it difficult to manufacture or repair military aircraft. Even the ability to build online networks is undermined by the lack of servers, access for which is needed by the semiconductor industry. Professor Newman elaborates that this trend—the shift from market access to network access as the cornerstone of economic coercion—is underwritten by the growth in influence of certain key firms (such as Boeing) which are controlled by Western powers. These firms are at the centre of the relevant networks which provide both physical goods and intangibles ,such as intellectual property, that are key to the Russian war effort.

MARKET BLOWBACK AND THE DIFFICULTY OF ASYMMETRIC COERCION

The private sector response has been even more dramatic. Many multinational firms have ceased, or are in the process of ceasing, operations in Russia after reconsidering their opportunities in an economy severely hit by sanctions, or fearing the reputational effects of remaining. This raises further questions about the effectiveness of sanctions, which are only deemed to be effective if they can be credibly removed in response to concessions. Yet, if the private sector de-risks so dramatically, it is not clear whether adversaries can be expected to come to the bargaining table. According to Dr. Kalyanpur, this throws into sharp relief the need for some form of 'forward guidance' in conjunction with the expanding tool kit of economic sanctions. In other words, we may be able to borrow the tools used to manage market expectations of monetary policy to make sanctions more targeted, more predictable, and thereby more effective.

Rachel Ziemba emphasised that the credibility of sanctions is further undermined by blowback in global markets, caused by spill over effects, particularly in commodities markets. Food and energy markets in particular remain stretched thin due to a severe mismatch in demand and supply; the demand for goods having increased during the pandemic, while the supply of those goods have been drastically curtailed in the wake of the war and pandemic-related supply chain issues. This has so greatly affected emerging markets, Ms Ziemba also pointed out, that is not only the credibility of sanctions that has been reduced, but their ability to deprive Russia of foreign exchange earnings as intended. The blowback in the commodities market had led to a large increase in the price of major Russian exports, thus keeping Russia afloat financially.

Ms Ziemba also stressed that the implication of these events is that there are no straightforward, asymmetric sanctions regimes for large countries. This is because the economic and financial spill over is too great, already altering global alliances as many countries dissent from the advanced economy coalition on sanctions. The role of the dollar in particular has been questioned, with emerging market countries depending on the 'moneyness' of the dollar: as a reserve asset, as a stable currency for trade invoicing, and as the basis for offshore liability issuance on the global wholesale money market. The perception that access to the dollar system is premised on geopolitical alignment has informed some of this pushback.

The nature of the Russian regime also inflects the use of sanctions. According to Ben Judah, the severe financial sanctions seen at the very beginning of the conflict reflected a misreading of the character of the Russian state. Many of the key individuals with purchase on public policy had on-shored their wealth and were therefore insulated from sanctions. Those who were least insulated from sanctions, with most of their assets abroad, also had the least influence domestically. Mr Judah raised the open question of how this crisis will alter the reorganisation of global financial elites' wealth, minimising the effectiveness of such sanctions, and how that reorganisation will affect other countries' attempts to fill the void created by the US and UK.

ECONOMIC COERCION AND THE NEED FOR 'GLOBAL KEYNESIANISM'

The main conclusion of the expert panel was that change to the form of economic coercion has inverted a key premise in the global economic order: while it is assumed by some commentators to be 'flat', it is in fact highly centralised. This centralisation provides for points of control. The US and its allies have been successfully leveraging this control over the last years. In light of these facts, other countries might try to develop their own economic networks, or at least subvert current ones. This direction depends on the way in which these new economic weapons are used, whether their use is predictable and proportional, and to what extent there are economic spill over effects. The experts suggested that, in order to ensure global economic cooperation, sanctions regimes of this magnitude must be accompanied by a form of 'global Keynesianism': a coordinated stimulus effort which allows for ways to offset the economic repercussions for emerging markets in particular. This will require both short-term measures to dampen immediate effects and—more importantly—long-term investments that minimise the fragility associated with a global economy made up of choke-points. ■

PARTICIPANTS

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LSE Global Economic Governance Commission

The LSE Global Economic Governance Commission is a forum for debating and redesigning global economic governance.

COVID-19 has presented the world with a new Bretton Woods moment. It has exposed the fragilities of the global monetary order and the dislocations in the global trading system. With economic damages rising and tax revenues falling, it has presented a new crisis for global development and demonstrated the overdue need for global tax coordination. As states have struggled to band together to overcome their shared challenges, it has made clear the difficult road ahead for the global climate agenda.

To steer the much-needed transformation of the rules, practices, and institutions of the global economy, The London School of Economics and Political Science and LSE IDEAS have convened the LSE Global Economic Governance Commission. The Commission brings together leading academics and policymakers around five core domains of global economic governance: monetary policy, trade policy, development policy, tax policy, and climate policy. The Commission hosts public and closed-door panels, lectures, and workshops on all matters relating to global economic governance. Event details are announced online by LSE and LSE IDEAS.

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