THE SANCTIONS WEAPON

Economic sanctions deliver bigger global shocks than ever before and are easier to evade

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Not since the 1930s has an economy the size of Russia's been placed under such a wide array of commercial restrictions as those imposed in response to its invasion of Ukraine. But in contrast to Italy and Japan in the 1930s, Russia today is a major exporter of oil, grain, and other key commodities, and the global economy is far more integrated. As a result, today's sanctions have global economic effects far greater than anything seen before. Their magnitude should prompt reconsideration of sanctions as a powerful policy instrument with major global economic implications.

Sanctions are not the only source of turmoil in the global economy. Energy prices have been rising since last year as the economic recovery from the pandemic encountered overburdened supply chains. Global food prices rose 28 percent in 2020 and 23 percent in 2021, and they surged 17 percent this year between February and March alone. The war has also harmed Ukraine directly as fighting has closed the country's Black Sea ports, blocking its exports of wheat, corn, sunflower oil, and other goods.

The effects of the loss of Ukrainian supply have been amplified by two even larger shocks:

the sanctions imposed on Russia by 38 North American, European, and Asian governments and the responses to those measures by global firms and banks. This barrage of legal, commercial, financial, and technological restrictions has drastically impeded Russia's access to the world economy. It has also vastly increased the range of commodities from both countries that are no longer finding their way onto world markets. Sweeping sanctions against Russia have combined with the worldwide supply chain crisis and the wartime disruption of Ukrainian trade to deliver a uniquely powerful economic shock. Additional sanctions on Russian oil and gas exports would magnify these effects further.

A different category

A look at the past century of economic history makes the significance of the sanctions against Russia even clearer. Even the strongest sanctions regimes of the Cold War period, such as UN and Western sanctions against Rhodesia (now Zimbabwe) and apartheid-era South Africa, or US sanctions on Cuba and Iran, did not target large economies. Some of the sanctions regimes currently in place are more stringent than those aimed at Russia—especially those on Iran, North Korea, and Venezuela. But these countries have much less weight in the global economy and international trade.

The impact of the sanctions on Russia belongs to an altogether different category. Russia is the world's 11th largest economy, and its role as the prime commodity exporter among emerging markets gives it a structurally significant position. Among advanced economies, only the United States, Canada, and Australia have a comparable footprint in global energy, agriculture, and metals markets. Moreover, since the end of the Cold War, more than two decades of advancing integration have made Russia a very open economy, with a trade-to-GDP ratio of 46 percent, according to World Bank data. Among the seven largest emerging markets, only Mexico and Turkey had higher shares in 2020 (78 percent and 61 percent).

In the past century, the 1930s is the only decade that offers a precedent for sanctions against states with a similar weight in the world economy. Within six weeks of Benito Mussolini's invasion of Ethiopia in October 1935, the League of Nations crafted a sanctions package against Italy, the world's eighth-largest economy. It was implemented by 52 of the roughly 60 sovereign states in the world at that time (Baer 1976). The measures included an arms embargo, a freeze on financial transactions, and export prohibitions on a number of raw materials vital for war production. But the most significant measure was a ban on all imports from Italy. This was possible because the Italian economy's structural current account deficit meant that such a ban hurt Italy more than it did the sanctioning states.

Wars of conquest

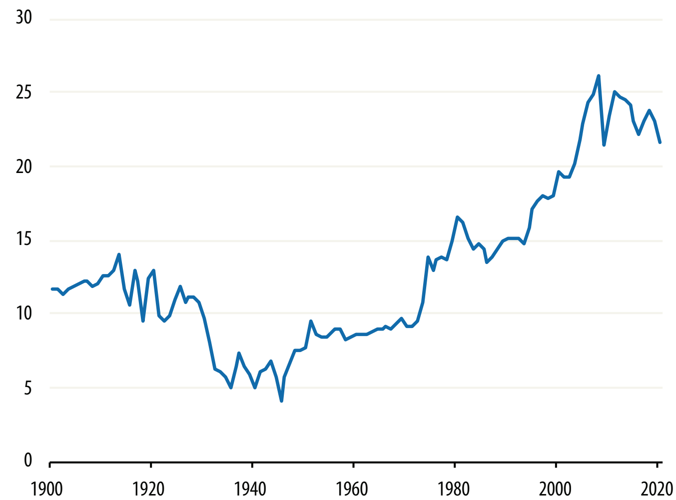
From October 1935 to June 1936, Italian industrial production fell by 21.2 percent, while in the first five months of sanctions, exports plummeted by 47 percent before stabilizing at roughly two-thirds of their pre-sanctions level. The League's ban on imports from Italy drove up international prices for foodstuffs such as meat, fruit, and butter as well as raw materials and manufactures such as wool, textiles, and leather goods. Crucially, the sanctions failed to stop the Italian conquest of Ethiopia, in large part because the United States and Germany, the world's largest and third-largest economies, were not League members and did not join the sanctions. As a result, Italy continued to import coal and oil (Ristuccia 2000) and managed to withstand eight months of serious hardship.

Japan was the world's seventh-largest economy in the late 1930s and a trading state even more open than Italy. Between the summer of 1939 and August 1941, a growing coalition of Western states seeking to restrain the Japanese war of conquest in China imposed sanctions that gradually diminished the number of available trading partners (Maddison 2006). The onset of World War II caused the British Empire and its colonies and dominions in Asia and the Pacific (India, Australia, New Zealand, and Canada) to restrict exports of strategic raw materials and prioritize them for intra-imperial use.

By the end of the decade, Japan was thus even more dependent than before on imports of raw materials (especially oil, iron ore, copper, and scrap metal) from the largest Pacific economy that remained neutral: the United States. In response to Japanese conquests in 1940 and 1941, the United States gradually escalated its economic measures until it finally imposed a full oil embargo, together with the British Empire

Trading up

The share of trade in world output is much higher today than it was in the 1930s.
(merchandise exports as a percent of world GDP)



Sources: Ortiz-Ospina, Esteban, and Diana Beltekian. 2018. "Trade and Globalization." Our World in Data; and World Bank. 2020. "Exports of Goods and Services." World Bank and Organisation for Economic Co-operation and Development data, Washington, DC.

and The Netherlands. It also froze yen reserves held in the United States (Miller 2007). By late 1941, Japan's trade had fallen by 20 to 25 percent in just 18 months. Faced with a collapse of its access to key imports, Japan attacked the United States and European colonies in Southeast Asia to secure the raw materials it needed to sustain its war machine. Whereas Italy had borne the brunt of embargoes against its exports, which reduced its ability to earn foreign exchange, Japan was hit more severely by a foreign asset freeze and a ban on its capacity to obtain vital imports from its one remaining large trade partner.

Global environment

The shock of the Great Depression had undermined much of the trust and cooperation that underpinned international political stability. Trade wars escalated into diplomatic disputes, initiating a trend toward the formation of political and economic blocs. As the guardian of the post–World War I order, it fell to the League of Nations to enforce sanctions against states that threatened world peace. The sanctions showed that Western powers retained considerable heft in the world economy. But the unpropitious circumstances of the Depression and lack of international fiscal and monetary cooperation meant that sanctions created further tensions and were ultimately incapable of preserving peace.

What this interwar history shows is that the global economic environment determines the form that sanctions can take and shapes their effects. The Depression was marked by an agrarian crisis, monetary collapse, and a downturn in trade. These developments diminished world exports, fragmented currency blocs, and drove global price deflation for much of the period between 1928 and 1939. On the one hand, this meant that export earnings were lower, as was the cost of decoupling. On the other, it made imports cheaper, ensuring a basic level of continued access to metals, foodstuffs, and energy. Sanctions were deployed in a world of growing autarky, where interdependence between national economies had fallen to its absolutely vital minimum. In the 1930s sanctions thus did only moderate damage to an already battered world economy. But they threatened national livelihoods enough to prompt military escalation.

By contrast, the global trade-to-GDP ratio is much higher today (see chart), and it is sustained by a highly integrated dollar-based global financial system. Instead of deflation, markets worldwide are experiencing strong inflation pressure. High commodity prices generate windfalls for exporters while encouraging energy-importing economies to transition to renewables. Meanwhile, increased financial market integration makes capital flows from advanced economies crucial to growth and investment in emerging market and developing economies. Today's world economy enjoys substantial gains as a result of this interdependence, as trade employs larger workforces and imports can be sourced from more places. But it also contains greater vulnerabilities, as nodal points in flows of commodities, financial transactions, and technology can be choked by supply chain issues or targeted by government sanctions.

Costs versus risks

The result of these changes is that today's sanctions can cause graver commercial losses than ever before, but they can also be weakened in new ways through trade diversion and evasion. At the same time, modern sanctions are less direct a threat than in the 1930s, lowering risks of military escalation.

Yet more broad-based market integration has widened the avenues through which sanction shocks spill over into the world economy. Twenty-first century globalization has thereby increased the economic costs of using sanctions against large, highly integrated economies. It has also multiplied the ability of these countries to engage in economic and technological rather than military retaliation. On the whole, the nature of the risks and costs of sanctions have changed, but the transmission channels through which they operate—higher commodity prices and transaction costs and bigger supply bottlenecks and trade losses—have remained the same, and they affect more people around the world.

It is rapidly becoming clear just how significant the spillover effects are of sanctions against countries in the top stratum of the global economy. As sanctions remove Russian commodity exports from world markets, prices are driven higher, putting pressure on the import bills and constrained public finances of net-commodity-importing emerging market and developing economies. Unsurprisingly, these are precisely the countries that have not joined the sanctions against Russia, since they are most at risk of a balance of payments crisis if sanctions on Russian exports are tightened over an extended period.

Policymakers today possess everything they need to avoid a repetition of the 1930s. Because the level of economic integration is far greater today, it will take much more disruption for fears of deglobalization to materialize. There are more economies rich enough to provide alternative sources of supply as well as export markets for countries forced to stop trading with Russia. Advanced economies have better fiscal policy tools than they did in the early 20th century and benefit from greater fiscal space than emerging market and developing economies. Whether they use these strengths to compensate for the massive stress that sanctions put on the world economy is ultimately a political choice. Many emerging market and developing economies face an acute combination of woes: high debt, the high cost of a transition to renewable energy, rising interest rates, and global stagflation. Sanctions-imposing Group of Seven and EU governments must take seriously the task of providing them with economic support.

It is in the interest of the well-being of the world population and the stability of the world economy to take concerted action to counteract the spillovers of sanctions on Russia. A number of policy adjustments could help. First, advanced economies should focus on long-term infrastructure investment to ease supply chain pressures, while emerging market and developing economies should make income support a priority. Second, advanced economy central banks should avoid rapidly tightening monetary policy to prevent capital flight from emerging markets.

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Third, looming debt and balance of payments problems in developing economies can be tackled through debt restructuring and increases in their allotments of the IMF's Special Drawing Rights, a type of international reserve currency. Fourth, humanitarian relief should be extended to distressed economies, especially in the form of food and medicine. Fifth, the world's major economic blocs should do more to organize their demand for food and energy to reduce price pressures caused by hoarding and competitive overbidding.

Unless such policies are put in place in the next few months, grave concerns about the world economic outlook for 2022 and beyond will be justified. It is high time for our thinking about the global economic stability implications of sanctions to catch up with the new realities of economic coercion. FD

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