Ad-hoc Task Force on Russia Sanctions

Leibniz Institute for Financial Research SAFE
Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Prof. Dr. Jan Pieter Krahnen
Scientific Director

Phone + 49 (0) 69 798 30060
krahnen@safe-frankfurt.de

Peace Research Institute Frankfurt PRIF
Baseler Straße 27-31
60329 Frankfurt am Main

Prof. Dr. Nicole Deitelhoff
Scientific Director

Phone + 49 (0) 69 959 10441
deitelhoff@hsfk.de

Policy note
Designing a rational sanctioning strategy*

27 February 2022

Summary

This policy note summarizes our assessment of financial sanctions against Russia. We see an increase in sanctions severity starting from (1) the widely discussed SWIFT exclusions, followed by (2) a blocking of correspondent banking relationships with Russian banks, including the Central Bank, alongside secondary sanctions, and (3) a full black-listing of the 'real' export-import flows underlying the financial transactions. We assess option (1) as being less impactful than often believed, yet sending a strong signal of EU unity; option (2) as an effective way to isolate the Russian banking system, particularly if secondary sanctions are in place, to avoid workarounds. Option (3) represents possibly the most effective way to apply economic and financial pressure, interrupting trade relationships.

Memo

In this memo we assume financial sanctions to aim for a clear and loud repudiation of the armed conflict waged on Ukraine, inflicting damage on the Russian economy and, perhaps, constraining further war efforts. There are different financial sanctions conceivable, and the exclusion of Russian banks from the SWIFT system, which had been labeled 'nuclear' option by some commentators, suggesting a particularly strong impact on the economy, is one of them.

SWIFT is an electronic messaging system enabling cross border financial transactions by offering a standardized and universally accepted communication tool. It does not, however, execute the financial transaction itself because, based on SWIFT messages, banks activate their network of correspondent banks to transfer the monetary payment to its clients abroad. Thus, the actual payment flow between countries is handled by the correspondent banking relationships, and SWIFT messages serve as its trigger.

What is the hypothetical effect of banning Russia from the SWIFT messaging system and/or the correspondent banking system, respectively?

---

* Contributors to the discussion underlying this note comprise, from the Peace Research Institute Frankfurt (Leibniz-Institut Hessische Stiftung Friedens- und Konfliktforschung) Christopher Daase, Nicole Deitelhoff, Stefan Kroll, Anton Peez, and from the Leibniz Institute for Financial Research SAFE (Sustainable Architecture for Finance in Europe) Ignazio Angeloni, Matthias Goldmann, Jan Krahnen, Carl-Georg Luft, Andreas Nölke, Loriana Pelizzon.

(1) **SWIFT:** If excluded solely from the messaging system SWIFT, Russian banks may find alternative means of communication to trigger payments from banks abroad (telex, fax, email). While tedious, less reliable, and more susceptible to fraud, payments remain possible. Moreover, Russia and China have developed their own, scaled-down version of a financial messaging system, which they may rely on. The longer-term consequences of a Russian exclusion may thus be a loss of universality of the SWIFT system.

(2) **Correspondent banking:** Blocking individual correspondent banking relationships to Russian counterparts is highly effective, and difficult to work around, but the latter is not impossible. E.g., banks may circumvent a prohibition to interact by channeling funds through third country banks which may be difficult to trace.

Therefore, financial sanctions - if they want to be effective - need to target correspondent banking directly, i.e. disallowing banks in Europe from doing business with some or all banks in Russia. Moreover, secondary sanctions are needed in addition, making workarounds sufficiently costly: For example, banks that help a bank in the sanctioned country to circumvent the imposed restrictions, risk losing their operating license within the EU.

Blocking interbank transactions may be extended to the Russian central bank, in which case foreign exchange transactions become near impossible.

Taking the arguments together, a SWIFT exclusion is neither the only nor the most effective instrument to inflict major costs in terms of earnings foregone on the Russian economy, as blocking correspondent banking is arguably more effective. That said, a policy of SWIFT exclusion will certainly help to achieve a unified position in Europe, which may be interpreted as a sign of solidarity among European countries and Ukraine. The opportunity cost of such an act lies probably in a loss of credibility and reputation of the messaging system itself.

(3) **Export/import ban:** As a third option we consider blocking the real transactions that underlie financial cross border transactions.

Sanctions that merely target the financial system must cope with its fungibility: some sanctions may be circumvented to some extent by relying on the multiplicity of cross-border relationships, and the diversity of financial contracts, including outright payments, credit contracts and financial derivatives. An effective sanctioning method will therefore target the **underlying real economic transactions directly**, rather than merely their financial overlay.

For example, closing a gas pipeline by government decree, or the halting of coal imports, will automatically bring the payment stream flowing from these transactions to a halt – irrespective of any SWIFT protocol or correspondent banking relationship. In all these cases, the blocking of transactions may require additional policy action to deal with the economic fallout.

The three instruments discussed in this policy note, (1) SWIFT exclusion, (2) correspondent banking blocking, (3) an outright export/import ban, may be seen as having different degrees of severity, representing different elements, or steps, of a rational sanctioning strategy. As always, a clear communication to the public, including the sanctioning goals, the likely cost for citizens, and their distribution over time is an integral part of the overall strategy. Here, we currently see a window of opportunity for public support.