“So, has Russia become Venezuela or is it still Iran?” the morning-show host on the few remaining independent media outlets in Russia, Echo of Moscow radio station, asked a Russian economist on Monday. (The station was shut down on Tuesday)
“We’ll go through the Iran phase,” Yevgeny S. Gontmakher of Moscow’s Higher School of Economics responded, “but what happens after that is hard to say.”

As Russia escalates the Ukraine war on the battlefield in Ukraine, the economic battlefield where the US and its allies and partners are retaliating is escalating to levels not expected by Russia. Unity among the US, its allies and partners has resulted in strong sanctions that are having an immediate negative impact on the Russian economy with more long-term impact yet to come. The severity of the sanctions was realized immediately by the Russian President who responded with the ultimate threat—the order to raise the nuclear alert level of his forces. One of the issues front and center on the US agenda is whether to escalate the sanctions further to include direct sanctions on Russia’s energy sector.

The objective of the sanctions to date, according to statements by the US and its allies, is “to hold Russia to account and collectively ensure that this war is a strategic failure for Putin” and that while he may make gains on the battlefield, “he will pay a continuing high price over the long run.” These actions, have been described as being specifically designed to impose immediate costs and disrupt and degrade future economic activity, isolate Russia from international finance and commerce, and as Treasury Secretary Janet Yellen stated, “significantly impair their ability to use the Russian economy and financial system to further their malign activity…. while mitigating impacts to Americans and our partners.” President Biden, in his State of the Union address, said that he would use every tool at our disposal to protect American businesses and consumers.

The sanctions were escalated to include removing selected Russian Banks from the SWIFT financial messaging system and unprecedented sanctions on Russia’s Central Bank that will restrict the Russian Central Bank’s access to much of its $643 billion in foreign currency reserves, undercutting Russia’s efforts since the annexation of Crimea in 2014 to buffer Russia from the impact of sanctions.

Along with freezing assets of the Russian Central Bank that are held in the United States and by US persons wherever located, the Treasury is imposing sanctions on the Russian Direct Investment Fund, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation. In the State of the Union, the President announced that the US was joining a number of European nations by closing US airspace to all Russian flights and followed that with new sanctions further targeting Russian oligarchs and their families, while France seized the yacht of one of Russia’s oil magnates, Igor Sechin.

Businesses have also begun to compound the economic damage as several major companies, including major oil and gas companies, announced that they would curtail their businesses or suspend their activities entirely in Russia. The sanctions against Russians and the consequent regulatory uncertainty,
The week opened with the ruble crashing, the Russian stock market shutdown, ordinary Russian citizens rushing to withdraw their money from the banks, and the head of the Russian Central Bank assuring that Russia has a system that can replace the SWIFT international payments system internally, and that all banks in Russia will fulfill their obligations and all funds on their accounts are secured. Russia’s central bank opted for an emergency interest-rate hike, doubling its interest rate, to combat a collapse in the ruble, and temporarily banned brokers from handling sales of securities by nonresidents.

The sanctions are being targeted to prevent Moscow from using the sanctions workarounds it has been preparing since its annexation of Crimea in 2014, particularly its $643 billion foreign currency reserves to buffer its economy.

But the sanctions very deliberately exclude Russia’s oil & gas sector - a major lifeline for the Russians. According to the Treasury Department, it “will exempt most energy related transactions” with an aim “to allow for steady energy supplies to global markets.” This is consistent with the earlier US sanctions. The Administration seeks to prevent both “unnecessary harm for consumers” by “ensuring the current supply of energy to the world remains steady” and to prevent “spikes in prices that would only pad the pockets of President Putin” given Russia’s energy exports.

As the sanctions escalate, Russia becomes more boxed in and the off ramps that the Russian President might accept to resolve the Ukraine war diplomatically, where he can save face, are becoming narrower and narrower. Even if Russia succeeds on the military battlefield in Ukraine and replaces the Ukrainian government, it still loses the economic battle. As one former IMF official said, “Cutting off access to global financial markets and to a country’s war chest of international reserves held in currencies of Western economies amounts to a crippling financial blow, especially to an economy like Russia’s that relies to such a large extent on export revenues.”

At this point the unified sanctions response plus Russia’s doubling down on its determination to achieve its conquest of Ukraine indicate that the sanctions will remain in place for an extended period of time, similar to sanctions imposed in 2014 in response to Russia’s annexation of Crimea that remain in place.

For Russia, this makes it even more important in the short and long-term that it pursues pathways to circumvent the economic sanctions well enough to keep Russia economically afloat, so Putin can remain in power and continue to pursue his expansionist agenda and ultimately create an alternative world order not dependent on the primacy of the US and the dollar.

At this point in time, Russia’s three main lifelines include:

- the sanction exemptions for Russia’s oil & gas industry, the lifeblood of the Russian economy
- SWIFT alternatives and cryptocurrency,
- expansion of economic relations with China and India, which are maintaining a neutral stance

While cutting off Russia’s energy sector might seem an obvious next step on the sanction escalation ladder, for the US and its allies the very difficult challenge is to work in unison to calibrate a sanctions policy that addresses those lifelines with responses that hurt Russia economically more than the West. Consequently, whether to escalate to sanctioning Russia’s energy sector is a central issue. The sanctions
policy must assure that Russia realizes that even if it wins the battle in Ukraine, it loses the war, making expansion beyond Ukraine not in Russia’s interests—while at the same time, not making expansion the only inevitable choice for a boxed in, economically trapped Russian leader, who is determined to stay in power and achieve his strategic objectives.

In the immediate term the concern is how Russia may retaliate, which includes a broad range of dangerous escalatory responses, including a shut-off of oil and gas to Europe, cyberattacks, and now including a nuclear response.

Longer term, the concern is what are the implications for global stability to have a country and economy as large as Russia, with thousands of nuclear weapons, a global pariah outside of the international economic order like the much smaller economies of Iran, North Korea and Venezuela.

In each of those cases, economic pressure has not led to regime change and has only increased the nefarious activities of the pariah countries, and pushed them closer to China, as they work to survive economically. The US must prepare for this outcome.

Following is a brief background on the considerations for further sanctions on Russia’s energy sector

**Challenging Russia’s Lifelines:**

**Oil & Gas:**

**Pressure mounting to cutoff Russian oil & gas:** As Moscow continues its advance in Ukraine, Republicans and some Democrats in Congress are pressing the Biden administration to consider imposing sanctions on Russia’s oil-and-gas industry, the lifeblood of the country’s economy, and banning Russian oil imports into the U.S. As a net energy exporter, Russia’s export revenue rises as crude oil and natural gas prices rise. Sanctions have been contributing to that rise in prices and, consequently, helping to replenish Russian coffers. The issue is causing a unique coalition of members ranging from conservative Senator Lindsey Graham (R., S.C.), moderate Sen. Joe Manchin (D., W.Va.) to progressive Sen. Ed Markey (D., Mass.). Ukraine’s President and Ambassador to the US are urging that the sanctions target oil and gas.

- Russia is continuing to supply vast amounts of oil and natural gas to the rest of the world and its two energy behemoths, Gas exporter Gazprom PJSC and oil company Rosneft PJSC, have not been targeted by major Western sanctions, because of their role in global energy markets.

- **Rosneft describes itself as Russia’s biggest taxpayer,** contributing a fifth of budget revenues. In Rosneft’s case, a Russian government-owned company holds more than 40% of shares. Gazprom contributed around 6% of budget revenues, based on International Monetary Fund data. The Russian government and companies controlled by it own more than 50% of shares in the company.

- **Russia was the world’s third-largest producer of petroleum** and other liquids (after the United States and Saudi Arabia) in 2020 providing roughly 10 percent of the global supply. Russia was the second-largest producer of dry natural gas in 2020 (second to the United States). Oil and gas exports account for 60% of Russia’s exports and 39% of federal budget revenue in 2019. The energy sector is estimated to contribute up to 25% of the country's gross domestic product (GDP).
• The European Union gets around 40% of its gas imports and more than one-quarter of its oil from Russia and for Germany it is up to 50% for natural gas, on top of 45% dependency on Russian coal and 34% on Russian oil. Europe is Russia’s main market for its oil and natural gas exports, and by extension, Europe is its main source for revenues.

• **More than 70% of Russia’s oil production is exported**

The U.S. still consumes far more oil than companies extract domestically, but is less reliant on Russia’s oil than Europe and takes only a small portion of its imported crude from Russia. America gets most of its crude imports from Canada, Mexico and Saudi Arabia. About 8% of U.S. imports of oil and refined products came from Russia last year. Of that, Russia’s crude made up roughly 3% of the nation’s imports. The U.S. buys Russian oil in part to feed refineries that need different grades of crude with a higher sulfur content to make fuel at top capacities.

The US and Allies Concerns:

• While the President responded, the day after his State of the Union, that nothing is off the table, the Administration, along with its allies in Europe, have been arguing that directly sanctioning Russia’s energy sector could prompt global oil prices to rise further and that it is not in the US strategic interests to limit global oil supplies in the short term. On February 24th, Deputy National Security Advisor Daleep Singh said at the White House, “We’re not going to do anything which causes an unintended disruption to the flow of energy as a global economic recovery is still underway...This is the one area where Russia has systemic advantage in the global economy.” In that context, the Administration has indicated that it would not support at this time an effort by Senator Manchin and others to prohibit the importation of Russian crude oil, petroleum products, liquified natural gas and coal.

• The concerns on both sides of the Atlantic of sanctioning Russian oil and gas include increasing the risk of a recession in Europe, the possible cutoff of energy supply to Europe, steeper inflation in the countries enforcing the sanctions as prices rise including for food, transportation, electricity, home heating, negatively impacting growth globally. Even without direct sanctions oil prices already jumped past $110 a barrel Wednesday.
• The impact of the price of oil if it goes to $150/barrel. The Conference Board estimates that that price increase will cause growth to surely be affected even if economies around the world do not immediately tip into recession: in the US, year-on-year economic growth may slow to 3.0 percent in 2022 vs. a forecast of 3.5 percent, and in the Euro Area, 3.4 percent instead of 3.8 percent forecast earlier this year. At the micro level, higher energy bills will pose new challenges for firms to contain costs and ensure production on competitive terms. However, a simulation by The Conference Board based on the Oxford Economics global model shows that the inflationary impact of a major and prolonged spike of oil prices would be even more significant than the impact on economic growth. 2022 annual average inflation could reach 7.6 percent in the US, and 5.1 percent in the Euro Area, more than a percentage point above earlier forecasts for the full year. Among the consequences: a further deterioration of household purchasing power, already under pressure from rising prices since early 2021.

• The Russian President’s public announcement about raising the alert of his nuclear forces clearly indicates that he sees the sanctions as an existential threat to Russia. Calibrating Russia’s response to direct sanctions on oil & gas have to be factored into the preparation for such an escalation.

• The US has been working with Allies, to ensure sufficient gas supply in the short term but no single country can match the amount of oil and gas supplied by Russia. Boosting gas shipments from the US is not a short-term answer because it requires not only building more export facilities in the U.S. — projects that take many years and billions of dollars to construct — but also more receiving terminals at Europe’s already congested ports. Also, multiple suppliers will be needed since no single supplier can match the extensive role that Russia plays in the European markets.

• Following the State of the Union, the International Energy Agency said its members, which include the United States and more than a dozen European nations, had agreed to release 60 million barrels of oil from their strategic reserves, a modest amount that did not impact prices. But it does flag for reassessment whether the US and allies, including Canada, need to increase their oil production to meet the challenges ahead for Europe.

• The Administration is also developing strategies with European countries for diversifying their energy supplies and has taken steps to block Russia’s access to technologies used by its oil-and-gas sector, which will have a longer-term impact on the industry and Russia’s status as a leading supplier of oil. The IEA just announced a plan for Europe to reduce its natural gas imports from Russia by a third within a year.

• The sanctions also target individual oligarchs and their families, including those in the oil and gas sector. Igor Sechin, CEO of Rosneft, who has been sanctioned since 2014, had his yacht seized by French authorities.

• The market is responding and the sanctions are also already indirectly hitting the export of oil from Russia. This raises the question as to whether further direct sanctions are necessary that would needlessly publicly force Russia to respond. Some oil buyers in recent days have shunned Russian crude, fearing that if sanctions were applied to Russian energy, their purchased oil could be rendered unusable. Also a number of energy companies have joined the growing list of businesses that have either curtailed their operations or withdrawn from doing business with Russia:
o Shell announced it would pull back from joint projects in the country and quit its role financing the now-halted Nord Stream 2 gas pipeline. In 2017, Shell and its financing partners each agreed to lend up to $1 billion to fund the pipeline. Shell said it would also exit other joint ventures with Gazprom, including its 27.5% stake in an offshore gas project in Russia’s far east that supplies around 4% of the world’s liquefied-natural gas market. Shell said it has around $3 billion in non-current assets in its Russian ventures and that it expects to book impairments.

o BP PLC said it would exit its nearly 20% stake in Russian oil producer Rosneft, under pressure from the U.K. government, and as international condemnation of Russia increasingly strained its economy. BP relies on Rosneft for roughly one-third of its oil-and-gas production and faces a potential financial hit of as much as $25 billion on the move. It isn’t yet clear how BP will exit its stake. BP said Chief Executive Bernard Looney and former CEO Bob Dudley resigned from Rosneft’s board. BP shares closed down 4% in London on Monday.

o Norwegian energy company Equinor AS A said, it would stop new investments in Russia and start exiting its joint ventures there.

o Norway’s large sovereign-wealth fund said it would divest its Russian holdings. Norges Bank Investment Management, the arm of the Norwegian central bank that operates the $1.3 trillion fund, is freezing investments in Russia while it works on a plan to divest from the Russian market.

o Several Scandinavian refiners, including Neste Oyj of Finland and Preem of Sweden, have said they halted purchases of Russian oil.

- There are also concerns that further direct sanctions on oil & gas will push Russia closer to China. As European refiners buy more oil from places like Saudi Arabia, Russian companies are increasingly trying to sell their crude to refineries in China and other Asian countries by offering them discounts. Energy experts assess that over the next few months Russian oil once shipped to Europe could go to China.

- Even without further energy sector sanctions, Russia may very well walk in the footsteps of the world’s pariah countries, destabilizing the international economic order. But additional energy sector sanctions will make that a certainty.