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Weaponisation of finance: the role of European central banks and financial sanctions against Russia

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ABSTRACT

In response to Russia's full-scale invasion of Ukraine, the Group of Seven (G7) countries and the European Union (EU) adopted a variety of financial sanctions, including the freezing of foreign reserve assets of the Central Bank of Russia held by other central banks. Drawing on a Principal-Agent framework and on speeches, newspaper articles and interviews with policy-makers, this study examines what it means for the ECB and the central banks of the Eurosystem to be involved in these sanctions. As a consequence of these actions, these central banks have been enlisted in monetary and financial warfare. Moreover, the three-fold objective of the ECB has de facto effectively been reweighted somewhat, as the focus on 'price stability' (primary objective) has become seemingly temporarily less prominent. Instead, the secondary and tertiary objectives have moved centre-stage, favouring geopolitical considerations.

KEYWORDS Central banks; ECB; financial sanctions; geopolitics; Principal-Agent; Russia; Ukraine

The Group of Seven (G7) countries, namely, Canada, France, Germany, Italy, Japan, United Kingdom (UK) and the United States (US), together with the European Union (EU), responded in concert to the Russia full-scale invasion of Ukraine (see European Commission 2022; Frum 2022). They adopted a vast array of economic and financial sanctions against Russia. Of particular importance were the financial sanctions that involved in various ways central banks, first and foremost, the freezing of the foreign reserves of the Central Bank of the Russian Federation or 'Central Bank of Russia' (CBR). These sanctions were generally seen to signal a break with the past and to be of considerable significance. For instance, the *Financial Times* published a leading article entitled 'The

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weaponisation of finance: how the west unleashed “shock and awe” on Russia’ (Pop *et al.* 2022), while *The Economist* (2022) published an article with the title ‘How new sanctions could cripple Russia’s economy: The brutal logic behind measures targeting the central bank’.

The European Central Bank (ECB) is the central bank of the EU member states that have the euro as their official currency. Together with the national central banks of all the EU member states that have adopted the euro it is called the Eurosystem.¹ Currently 19 (soon 20) member states have adopted the euro.² The ECB has as its stated primary objective, ‘price stability’, followed by other objectives, as elaborated below. The ECB is a central bank without a political equivalent counterweight at that same level (Elgie 2002: 193). Its independence is firmly embedded in the EU treaty and its mandate is, first and foremost, to safeguard price stability. Given this unusual status, involving the ECB in financial sanctioning could be problematic. It could politicise the central bank by dragging it into the realm of geopolitics, which could be detrimental to its ability to meet its objectives. It could also potentially impact the perceived independence and accountability of this non-majoritarian institution, which, in turn, could lead to reduced public support for it (De Haan 1997; Heldt and Mueller 2021; Majone 2001a; Verdun 1998).

We find it puzzling that the ECB has become involved in financial sanctioning: in the short-run, these measures could be destabilising for the economic and financial systems, violate the principle of an open market economy, could plausibly lead to higher prices, thereby increasing inflation and thus threatening price stability (the primary objective of the ECB). Furthermore, the involvement of the ECB in financial sanctioning could also be seen as challenging its independence from the political authorities, which is enshrined in the Treaty and national legislations. Finally, forcing a major player (Russia) out of the international financial system politicises the system and risks undermining it. In turn, this could be detrimental to financial stability. In sum, what does it mean for the ECB and the Eurosystem to be involved in financial sanctioning against Russia?

By adopting a Principal-Agent framework and drawing on speeches, newspaper articles and interviews with policy-makers, we examine various ways in which the ECB and the Eurosystem have been involved in financial sanctions during the war in Ukraine in 2022. We argue that, as a consequence of these actions, central banks have been enlisted for monetary and financial warfare. We posit that there has *de facto* been a rebalancing of the stated objectives of the ECB, which has focussed less firmly on ‘price stability’ (primary objective) and has favoured a broader set of other objectives, including European integration and geopolitical goals. The principals (EU member state executives) decided to

act swiftly to punish Russia by imposing financial sanctions. The ECB and the Eurosystem (the agent) were required to comply with this legislation, even if it could lead to difficulties in meeting their primary objective. Yet, the agent did not push back. Rather, it has implemented the law. The challenges of these decisions may be that the agent in the medium or long run will have a harder time executing its primary objective given to it by the principals.

This article is structured as follows. The second section reviews the literature on the ECB in times of crisis and outlines the Principal-Agent approach that informs our analysis. The third section examines the financial sanctions adopted against Russia since February 2022 by focussing on those carried out by central banks. The fourth section discusses the involvement of the ECB and the Eurosystem in financial sanctioning in light of their constitutional independence and their mandated objective to pursue price stability. The final section, reflects on how our article speaks to the broader debate on the weaponisation of central banking and the geopolitics of finance.

State of the art and theoretical framework

The ECB in times of crises

Over the last decade, political scientists interested in central banking in Europe have mostly focussed on the central banks' responses to the 2007–2009 international financial crisis and the sovereign debt crisis that began in the euro area in 2010 (see, *inter alia*, Macchiarelli *et al.* 2020). Some scholars have discussed how the independence of central banks can turn into 'loneliness' in times of crisis (Mabbett and Schelkle 2019) and how the central banks have responded to contestation from the public (Moschella and Diodati 2020) as well as from elected officials (Ferrara *et al.* 2022). Other scholars have looked at the interaction between the ECB and the Troika (Heldt and Mueller 2021; Henning 2017; Lütz *et al.* 2019), the role of the ECB in the establishment of Banking Union (Epstein and Rhodes 2016; Glöckler *et al.* 2017; Howarth and Quaglia 2016), the ECB's actions as lender of last resort (Ban 2020), and its 'whatever it takes' to save the euro (Hodson 2013; Lombardi and Moschella 2016).³ During crises, the ECB also provided swap lines intended to support countries in need (Spielberger 2022),⁴ but also to 'enhance the euro's international role' (Panetta 2020; Panetta and Schnabel 2020). Although these scholarly works have adopted different theoretical frameworks, their findings suggest decisive action on the part of the ECB.

Focussing once again predominantly on the political science literature, some authors have explained the role of the ECB from a neofunctionalist perspective (Niemann and Ioannou 2015). Others have pointed out the

leadership of the ECB (Schoeller 2018; Verdun 2017); its self-empowerment (Heldt and Mueller 2021); its infrastructural power (Braun 2020); and its ideational and institutional power, especially in the so-called ‘slow burning phase’ of the sovereign debt crisis (Carstensen and Schmidt 2018; Schmidt 2016). More recently, political scientists have considered the role of the ECB in dealing with the economic challenges posed by the pandemic, although most of these works offer only a fleeting analysis of the ECB (see, *inter alia*, Dimitrakopoulos and Lalis 2020; Schmidt 2020; Genschel and Jachtenfuchs 2021; Jones 2020). Some authors have focussed on one specific aspect of the ECB’s actions, such as the role of monetary policy (Quaglia and Verdun 2022) and banking supervision (Quaglia and Verdun 2023) in dealing with the pandemic-related economic crisis. So far, however, given the relative recency of the situation, to the best of our knowledge, no scholarly work has yet analysed the actions of the ECB in the context of the war against Ukraine – more specifically, the role of the ECB and Eurosystem national central banks in financial sanctioning against Russia.

Principal-Agent framework applied to the ECB

The Principal-Agent approach has been used to account for the establishment and functioning of non-majoritarian institutions, including central banks (Gilardi 2008; Maggetti 2009; Thatcher and Stone Sweet 2002). Non-majoritarian institutions have the following features: i) they have been delegated the authority to govern specific domains of activity; ii) they are not directly elected; iii) and their decisions are subject to override on the part of elected politicians only under conditions prescribed by law (Thatcher *et al.* 2022). According to the Principal-Agent framework, the Agent is delegated certain functions by the Principal and acts on behalf of the Principal.

Two main logics drive delegation (Majone 2001b): one logic is informed by the need for technical expertise, whereby Principals delegate certain functions to Agents, subject to constraining control mechanisms; the second logic is informed by the quest for credible commitments, whereby principals deliberately provide a considerable degree of independence to the agent so that it can effectively conduct policies to which the principals themselves could not credibly commit (Pollack 2003). In fact, according to the traditional theory of delegation, principals face ‘commitment problems’; individual principals might have an incentive to defect from commitments taken, *de facto* free-riding on others. To avoid this outcome, the principals delegate certain functions to non-majoritarian institutions that are sometimes endowed with a considerable degree of independence from their political masters. Notable examples are central

banks and courts (Majone 2001b). The Principal-Agent approach has in the EU context often been applied to explain the relationships between the political authorities in the member states and supranational EU bodies (Franchino 2007; Kassim and Menon 2003; Pollack 2003), notably, the Court of Justice of the EU and the ECB (Elgie 2002; Hodson 2009).

We are not the first to apply the Principal-Agent framework to explain the establishment of the ECB, the conduct of the tasks delegated to it, and its relationship with the political authorities (for earlier works, see Majone 2001a⁵; Elgie 2002; Hodson 2009; for a more recent study, see Genschel and Tesche 2022). In this framework, the member states – gathered in the Council of Ministers/European Council – are the Principal. The ECB and the Eurosystem are the agent to which certain functions have been delegated. The Eurosystem is itself a composite Agent, as it brings together the ECB and the national central banks of the EU member states that have adopted the euro. The main decision-making body of the ECB, is the Governing Council, which is composed of the governors of national central banks of the countries in the euro area and the members of the ECB's Executive Board based in Frankfurt.

Certain functions have been formally delegated to the ECB through treaties (Section 6 in the Treaty on the Functioning of the European Union) – notably, the conduct of monetary policy for those countries that have adopted the euro – or other EU legislation – notably, banking supervision in the euro area (Howarth and Quaglia 2016). Other tasks have been informally delegated to the ECB or have been *de facto* taken over by the ECB and Eurosystem national central bank, especially in times of crisis. Notable instances were certain aspects of financial crisis management (first and foremost, the function of lender of last resort), as well as contributing to safeguarding financial stability. Moreover, in the context of the sovereign debt crisis, but also during the pandemic, the ECB took it upon itself to signal very clearly that it would do 'whatever it takes to preserve the euro' (Draghi 2012). In so doing, the ECB implicitly agreed to provide unlimited support to financial market institutions; *de facto* acting as lender of last resort to banks and sovereigns (Ban 2020).

The ECB and Eurosystem national central banks (the Agent) have been given a clear mandate by the member states (the Principal) concerning monetary policy. Article 127 of the consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (2016/c 202/01) reads that the primary objective of the ECB and Eurosystem national central banks 'shall be to maintain price stability'. 'Without prejudice to the objective of price stability', the ECB 'shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union'. The ECB 'shall

act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.' Henceforth, we refer to these three successive sentences in Article 127 as, respectively, primary, secondary and tertiary objectives of the ECB (on the secondary mandate of the ECB, see Van 't Klooster and de Boer 2022).⁶ These objectives are not immediately in line with the imposition of sanctions.⁷ In fact, in the short- or medium-run these measures could be destabilising for the economic and financial systems and could threaten price stability.

Even before February 2022, inflation in Europe and North America was higher than in the past three decades (International Monetary Fund 2022). During the course of 2022, inflation ramped up further – more than had been expected at the start of the year. The causes of this inflationary trend were manifold. Global value chains were disrupted during the pandemic, and, once the pandemic receded, the supply side did not recover as quickly as the demand side, boosting commodity prices. After that, the Russian invasion of Ukraine and the subsequent economic and financial sanctions adopted against Russia contributed to the further disruption of trade in commodities, while Russia manipulated commodity prices in reaction to these sanctions (Kalish 2022). In fact, as elaborated upon in the following section, the revenues obtained through the sale of oil, gas, and food commodities, together with the imposition of capital controls, were Russia's main defences against sanctions, in particular, once the foreign CBR accounts were frozen and could not be deployed. In addition, non-Russian companies and banks, fearful of violating sanctions, became averse to doing business with Russian counterparts, further disrupting key supply chains. Overall, the sanctions against Russia contributed to the sizable increase in the prices of key commodities, which, in turn, fuelled inflation (Mulder 2022).

Moreover, the involvement of central banks in financial sanctions affects the relationship between the political authorities (the Principal) and the central bank (the Agent). It could have implications for the perceived or real independence of the central bank from the political authorities and the politicisation of the ECB (for a discussion of ECB's politicisation see Tortola 2020; Spielberger 2022). Article 130 of the TFEU states that 'When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national

central banks in the performance of their tasks.' Article 127 lists the tasks assigned to the ECB, namely, to define and implement the monetary policy of the Union; to conduct foreign-exchange operations; to hold and manage the official foreign reserves of the Member States; to promote the smooth operation of payment systems. The adoption of financial sanctions towards third countries is not mentioned among the tasks delegated to the ECB – these types of financial sanctions are tools of foreign policy,⁸ which is ordinarily outside the remit of central banks. However, during war-like circumstances, central banks are asked by governments to play their part. The challenge here is to determine the impact of this demand on central banking.

In order to gather empirical material for this article, we carried out a systematic survey of press coverage, consulted a variety of policy documents as well as speeches given by members of the Executive Board of the ECB. During the period August–November 2022, we also conducted six semi-structured elite interviews with central bankers and key observers in the EU and the US. The interviews lasted about one hour and both authors were present at each (virtual) interview with the respondent or respondents. We took the information collected through these confidential interviews as partial information and triangulated it with other sources, which we prefer to cite in-text whenever they confirmed information gathered through interviews. Given the confidentiality of the interviews, we are mostly unable to attribute specific passages to them.

Financial sanctions against Russia in response to its invasion of Ukraine

The bulk of the scholarly literature on sanctions focuses on the role of the US, which has been the main instigator of sanctions over the past few decades. Yet, the EU has also embarked on a number of sanctions (Borzyskowski and Portela 2016). Whilst there were divergent views among EU member states on the matter, the EU managed to keep up various sanctions against Russia after the latter occupied Crimea (Portela *et al.* 2021). In the present article, we are not considering traditional economic sanctions and their effectiveness (for an overview of this literature, see Özdamar and Shahin 2021). Rather, we focus on financial sanctions deployed by central banks. Of particular interest is a high-profile type of financial sanctions, namely, those targeting the foreign reserves of third-country central banks.

On 26 February 2022, the leaders of the G7 (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) and the European Commission issued a joint statement, condemning Russia for its attacks on Ukraine and adopting a set of economic and financial sanctions

(European Commission 2022). The financial sanctions consisted of: i) restrictive measures to prevent the Russian central bank from deploying its international reserves in ways that undermined the impact of the economic sanctions adopted against Russia; ii) the removal of selected Russian banks from the SWIFT messaging system so as to disconnect these banks from the international financial system and harm their ability to operate globally and from the real time gross settlement systems used by central banks; iii) the freezing of financial assets of sanctioned companies and individuals (including, Russian officials and elites close to the Russian government, as well as their families). It was also agreed to limit the sale of citizenships to Russians (European Commission 2022).

An innovative type of financial sanction deployed at this time was the freezing of foreign central bank assets. The *Wall Street Journal* (2022) noted that targeting the reserves held by CBR was ‘the most powerful weapon in the West’s financial arsenal’, and was designed to strike at the heart of Russia’s financial system. Along similar lines, Meadway (2022) argued that this was ‘an economic weapon’ that could ‘be utilised at no economic cost to those wielding it’ and so it was the ‘primary weapon’ of the financial sanctions against Russia (see also Bernstam 2022). Taking with due caution some excited commentaries, these financial sanctions aimed to cut Russia off from world financial markets making it much more difficult to finance the war (Davis *et al.* 2022).

The CBR and its international reserves

The freezing of the foreign reserves of the CBR is an almost unprecedented step in the world of central banking. It violates a tradition of respecting the sovereign immunity of central banks, even though advanced economies have frozen central bank accounts before, for instance, those of Iran (Congressional Research Service 2022). Sony Kapoor (cited in Fairless 2022) likened the freezing of the foreign reserves of the CBR to ‘a nuclear bomb in the world of global finance’. It was the first time ever that a coordinated action by all G7 jurisdictions was taken against a central bank and none of the more than sixty central banks that are members of the Bank for International Settlements (BIS) has ever been the target of financial sanctions (Kirschenbaum and Véron 2022).⁹ The CBR is not only a member of the BIS; it also sits on the Financial Stability Board and the Basel Committee on Banking Supervision. The handful of precedents for this kind of action had mostly targeted smaller and less well-connected economies, such as Iran, Venezuela and North Korea. There had not been sanctions on this kind of scale against a country such as Russia – a country with considerable geopolitical might

and economic size, which at the end of 2021, was considered the eleventh largest economy in the world.¹⁰

In order to understand how this type of financial sanctions works and why it can be so impactful, let us briefly rehearse the functions of a central bank and its international reserves in general and then discuss the specific case of the CBR. Central banks are at the centre of national financial and banking systems. They act as a ‘lender of last resort’ for domestic banks. They also step in when necessary to defend the value of the national currency, mainly by using central bank reserves. Central bank reserves include gold (mostly held domestically)¹¹ and foreign reserves, which are usually held abroad in foreign currencies (generally, dollars, euros, pounds, yen, and, more recently, also renminbi), and are often invested in government bonds of other countries as well as corporate securities and are held at accounts with other (major) national central banks, commercial banks and clearing houses (Bernstam 2022).

A central bank holds foreign reserves for a variety of reasons, such as to keep the exchange rate of the home currency stable by selling or buying the currency against other currencies; to facilitate payments in different currencies between different countries; to lend foreign currencies to domestic banks. In emergency situations, such as wars and the imposition economic and financial sanctions by foreign countries, a central bank can draw upon its foreign reserves to mitigate the effect of sanctions and help the national government to sustain the war effort. In fact, the country needs to buy essential imports for the war, but foreign suppliers are unlikely to accept payments in domestic currency. If the central bank has access to its foreign reserves, those can be used to that end.¹² If the foreign reserves of the central bank are frozen, the central bank needs to resort to capital controls, for instance, by forbidding residents from moving foreign currency abroad, imposing strict limits on the amount of foreign currency that they can withdraw from domestic banks and forcing exporters to convert part of their export earnings into domestic currency, so as to prop up the foreign exchange reserves (Davis *et al.* 2022). Moreover, if the central bank has no access to its foreign reserves, it is unable to use them to defend the national currency, which depreciates, while the central bank is forced to raise interest rates.

Publicly available data on the international reserves of the CBR need to be taken with a pinch of salt, however, as it is difficult to find reliable sources (see Hardie and Hinge 2022; Jones and Cotterill 2022). Furthermore, there are discrepancies (at times, large ones) concerning the data provided by different sources, even though there is agreement on some numbers. In the years preceding the 2022 invasion of Ukraine (especially from the invasion of Crimea onwards), the CBR built up its reserves (Central Bank of Russia 2022a, 2022b), which, in early February

2022, were worth about \$643bn (Central Bank of Russia 2022a: 22; Council of the EU 2022a). Approximately 40% of these reserves were held in North America and Europe, where Germany and France together accounted for roughly 25% of Russia's international reserves. Around 17% of the reserves of Russia's central bank were held in China (see Fairless 2022; Table 1, see also Central Bank of Russia 2022b; Vallée 2022).

The immediate short-run effects of sanctions were dramatic – the rouble depreciated by approximately 50% in March 2022 and the CBR increased its benchmark interest to 20% in the same month,¹³ while Russian sovereign debt was downgraded to junk status, even though the country had a relatively modest level of public debt prior to the invasion of Ukraine. In addition, the sanctioning of the CBR led Russian depositors to attempt to liquidate their bank deposits, thereby putting the entire Russian banking system under stress (Kalish 2022). The sharp decline in the value of the rouble, the shortage of imported goods and rising prices in Russia caused a substantial acceleration in Russian inflation (which averaged 17% from March to May 2022) and reduced the real purchasing power of Russian consumers.

Yet, as the months progressed, the effects of the financial sanctions, including the freezing of central bank assets, proved to be less devastating than initially thought (Demertzis *et al.* 2022; Euronews 2022). We identify three broad reasons. First, the Russian authorities adopted countermeasures, capital controls and obliged Russian exporters to sell 80% of their foreign currency earnings to the central bank (Central Bank of Russia 2022a: 3–4; Davies 2022). These dollars and euros then flowed into the CBR's accounts at commercial banks, and the central bank was able to supply these dollars back to banks or companies (Davies 2022). Moreover, Russia also increased the prices of key commodities as a response to sanctions. Second, there were work-arounds concerning the financial

Table 1. Geographical distribution of the Bank of Russia's official reserve assets in %.

Russian language and Russian Script	English translation	01.01.2021	01.01.2022
Золото в хранилище Банка России	Gold in the vault of the Bank of Russia	23.3	21.5
Китай	China	14.2	16.8
Германия	Germany	10.8	15.7
Франция	France	10.2	9.9
Япония	Japan	12.7	9.3
США	USA	6.8	6.4
Соединенное Королевство	United Kingdom	4.4	5.1
Межгосударственные организации	Intergovernmental organisations	5.0	4.3
Канада	Canada	2.3	2.7
Австрия	Austria	2.3	2.5
Прочие страны	Other countries	8.0	5.8

Source: Russian version of the Annual Report of 2021, page 112 (CRB 2022b), own translation. These data are broadly in line with those reported by Vallée (2022) for mid 2021.

sanctions adopted, which included a ‘carve-out’ that enabled most energy-related transactions with the CBR and some Russian banks, notably Gazprom, in order to allow oil and gas to keep flowing from Russia to the rest of the world. The EU, the US and other G7 members froze foreign currency accounts that the CBR held in their jurisdictions, but the CBR also had foreign currency accounts with commercial banks in Russia, such as Gazprombank, and was able to receive dollars into those accounts.¹⁴ Thus, the fact that Russia was still allowed to sell all fossil fuels enabled the country to use the foreign currency earnings from those sales to support the rouble (Davies 2022). Third, not all G20 countries adopted the sanctions, which also made it easier to find ways to bypass them (Pisani-Ferry 2022).

Financial sanctions and EU central banks

Following the general agreement reached at the G7, the decisions concerning the adoption of financial sanctions against Russia were taken in the EU by the political authorities, i.e. the national governments of member states gathered in the Council. Since sanctions are part of the EU toolkit of its Common Foreign and Security Policy (Council of the EU 2022b), typically, such decisions are prepared by the Committee of the Permanent Representatives of the governments of EU member states (COREPER). Formal decisions are taken in the Council of the EU, usually sitting in the configuration of Foreign Affairs. Central banks are not formally involved in the Council of the EU, but the ECB has a seat in the Ecofin Council. In the case of the financial sanctions against Russia, the ECB and the Commission were asked by the informal Ecofin in February 2022 ‘to assess the consequences of cutting further the access of Russian institutions to the financial system’ as reported in a press statement (EU Ministers for Finance and European Commission and the European Central Bank 2022).¹⁵ The views of Ecofin then went to COREPER, which prepared the dossier for the Council meeting where the national governments of the member states decided on sanctions.

The financial sanctions against Russia adopted through the Council Regulation of 28 February 2022 comprised: restrictions concerning the access of certain Russian entities to EU capital markets; prohibition for EU banks to accept deposits exceeding certain amounts by Russian nationals; prohibition for EU central securities depositories to hold accounts of Russian clients; prohibition to sell euro-denominated securities to Russian clients; prohibition of transactions with the CBR and the freezing all its assets.¹⁶ Similar financial sanctions were subsequently adopted against Belarus. Once adopted, sanctions were then implemented at the national level by the national competent authorities, which are

national central banks, treasury ministries, other ministries (e.g. interior ministries) and financial supervisory authorities, depending on the member states.

The ECB and Eurosystem national central banks were involved in financial sanctioning against Russia in several ways. First, they froze the assets of the CBR by blocking its accounts, and excluded sanctioned Russian banks from the real time gross settlement system of the Eurosystem – the TARGET system (interview 4). Besides the ECB, the Eurosystem national central banks that managed the foreign reserves of the CBR were also involved in freezing those assets. For instance, the Banque de France has a lot of client central banks that ask the Banque to manage their reserves, or part of their reserves. The Banque de France has the chain of all that is needed to manage the reserves of other central banks (including those of the CBR), ranging from asset management to the provision of custodian and settlement services (interview 5). Second, if certain transactions or certain mergers involved sanctioned financial institutions/individuals, the ECB and Eurosystem national central banks would block them. For instance, an interviewee stressed that the reason that the European subsidiary of the Russian Sberbank was failing in the spring of 2022 was because it could not receive funds from Russia as a consequence of the sanctions imposed (see also Arnold and Astrasheuskaya 2022).

Third, the ECB and Eurosystem national central banks that were also banking supervisors were responsible – together with other authorities, such as the anti-money laundering authority and the finance ministry – for monitoring the banks they supervised implemented the financial sanctions against Russia (i.e. the freezing of the CBR's assets on the books of commercial banks as well as the assets of sanctioned Russian companies and individuals). On the one hand, the ECB and national central banks were not responsible for imposing sanctions on banks; instead, banks were required to comply with EU sanctions regulations (European Central Bank – Banking Supervision 2022). On the other hand, the ECB and national central banks with supervisory competence were involved by wearing their SSM 'hat' (interviews 1, 3, 4). In fact, the ECB-SSM asked banks in the euro area to monitor account transactions of Russian and Belarusian clients, including EU residents. 'While it is not the ECB's role to police sanctions, the supervisors are concerned that banks in the bloc could incur hefty fines if their clients channel money on behalf of sanctioned individuals' (Reuters, 16 March 2022), including checking the destination and purpose of transfers and preventing banks from accepting deposits above €100,000. Moreover, together with Eurosystem national central banks that had supervisory competences,

the ECB had a role in ensuring that the banking system stayed ‘resilient to shocks’ (ECB – Banking Supervision 2022). For instance, the National Bank of Belgium supervises Euroclear, which is a ‘custodian bank’ that holds a lot of securities owned by Russians and by the CBR. So, when the financial sanctions were adopted, the supervisors had to check what would happen if these securities and cash accounts with Euroclear were blocked (interview 5).

Interviews conducted for this study suggest that the ECB and the Eurosystem were aware of the discussions on sanctions taking place at the political level, but were not formally involved in the political decisions. However, the ECB was present at Ecofin meetings, and could use the right to intervene and express views on certain matters. In formal terms, ECB and national central banks are not involved in the adoption of sanctions, only the member states are involved in the decision making in the Council (deliberative body), while the European External Action Service and the Commission prepare the proposals upon which the Council decides (interview 2). Once decisions were made by the political authorities, the ECB and national central banks stated that they would implement all sanctions decided by the EU and European governments, including freezing the foreign reserves of the CBR. For instance, the member of the ECB’s Executive Board, Fabio Panetta (2022a), pointed out the ECB’s willingness to ‘swiftly implement the sanctions decided on by the European Union’. The ECB did not question the legislation on financial sanctions – which was not seen as affecting either the monetary policy remit of the ECB, or its independence – but worked with it as a condition in which it had to operate. In the ECB’s accounts of its monetary policy meetings that followed the decision of 26 February, financial sanctions were only mentioned as something that was external to the ECB. The ECB’s estimation of the correct policy to pursue with reference to its primary objective – price stability – still concentrated on macro-economic models and whether the increase in prices was temporary and whether the sanctions would produce ‘strains in money markets or liquidity shortages’ (European Central Bank 2022a). In each subsequent account of the monetary policy meetings, it appeared that the Governing Council was however surprised by persistently high inflation (European Central Bank 2022b, 2022c). The meeting in June only mentioned the sanctions once, stating that ‘Looking at the June staff projections, the question was raised whether the assumptions behind the baseline were too benign in terms of the impact of the sanctions and the war’ (European Central Bank 2022c).

All six people we interviewed agreed that central bankers regard sanctions as a geopolitical issue, on which they do not have a say, unless it

has an impact on their tasks (interviews 1, 2, 3, 4, 5 and 6). They differentiate the monetary and supervisory realm from the political realm and see themselves as a technocracy that executes sanctions, according to the law. The ECB regards itself as an institution of the EU and accepts the political leadership there (interview 6). Moreover, the fact that the decision to adopt sanctions was taken by unanimity at the political level made it less difficult for the ECB to accept executing sanctions (interview 5). Yet, in interviews, central bankers admit that they faced a dilemma: the relationship between the sanctions and higher energy prices and inflation was a difficult one. However, one interviewee remarked that the consideration of the potential trade-off with inflation was made entirely and exclusively by political leaders (interview 1). Another interviewee admitted that central banks, including the ECB, underestimated the duration and elevated level of inflation. The ex-post inflationary effects were higher than expected and are likely to prevail longer than was initially foreseen. As time went by, the ECB and the Eurosystem became more open about their forecasting mistakes (interview 6). A third interviewee made the point that the effects of the measures taken by central banks were much less impactful than the developments in commodity markets (interview 3). Finally, one interviewee remarked that central banks were seen by governments as the institution that can do it all (interview 4), overburdening central banks with too many (at times conflicting) tasks.

On the one hand, the involvement of the ECB in financial sanctioning had the effect of rendering the stated objectives of the ECB further removed from its primary focus on 'price stability', considering, instead, a broader set of goals, including European integration and geopolitical concerns. Thus, the ECB regarded as its role as one in which price stability was defined broadly, interpreting the clause to support 'the general economic policies of the Union' as a key objective, in this case as required by law. For instance, the ECB President Christine Lagarde (15 March 2022) noted that the ECB 'will implement the sanctions decided by the EU and European governments.... The events of the past few weeks have demonstrated Europe's strength and resolve in times of peril. We have agreed on an unprecedented set of sanctions that hit their target hard, but also have material costs to ourselves. We have shown that we are prepared to pay the price necessary to uphold the universal values of peace, freedom and prosperity'.

On the other hand, by complying with the sanctions without apparent push-back, the ECB ran the risk of not being seen to be advocates of price stability, which is its primary objective. With inflation having crept up in the twelve months prior to Russia's invasion of Ukraine, the risk

of a further increase in inflation was considerable. Of course, it was not known how long the invasion would last, or what the effect of the measures would be on inflation (interviews 5 and 6), but it was clear that it would lead to insecurity and possible disruption of supply-chains. The energy dependency on Russia was well-known – moving away from that would increase prices and so would retaliatory measures adopted by Russia in response to sanctions. ‘There is a literature on fiscal dominance on monetary policy in ordinary times, but there is also political dominance during wars.... In war situations, price stability is a second-order objective, but we are not in a real war’ (interview 5). Moreover, there is the risk of stagflation: an inflationary shock coupled with a recession (interview 5). The ECB is more vulnerable than other central banks to legitimacy challenges because of its very high degree of independence and because it does not have a counterpart at the same level of governance. There is no fiscal or political authority that is on par with it.

Furthermore, the execution of financial sanctions by the ECB and central banks more generally enlists them for monetary and financial warfare. Central banks are aware of the potential risks ensuing from this. One interviewee noted that the ability to cut off a central bank from the financial system – used as a weapon – was new. Several interviewees pointed out the importance of operating without political constraints. They warned that if the financial system can be used as a weapon, then there is a risk of a parallel financial system being set up,¹⁷ undermining the global financial system and creating a financial stability problem (interview 5). The weaponisation of finance and the use of blockages as a weapon in this way could set a bad precedent. Yet, another interviewee added that, while global economic and financial integration are going to suffer due to the pandemic first and then the war in Ukraine, it is not the role of central banks to argue that the objective of financial integration should be dominating political considerations – central banks should be takers in this (interview 6). A couple of interviewees expressed some uneasiness about central banks getting involved in financial sanctioning: once you start freezing the accounts of other central banks, the question is when does one stop? They wondered whether if one were to get into this practice, could one imagine that the EU could also start freezing the assets of the central bank of Hungary (interview 4).

In the case of the ECB and Eurosystem national central banks, the deployment of financial sanctions against Russia was intertwined with the international role of the euro.¹⁸ One interviewee noted that these sanctions would have long term implications for the euro and its ambitions to become a leading international currency (interview 5) (see also Wigglesworth *et al.* 2022). Fabio Panetta (2022b), a member of the ECB’s

Executive Board, remarked that ‘the “sharing of sovereignty [through EMU and NATO] matters at a time when money and finance are weaponised through sanctions. The euro is the currency of the Union and the ECB is playing an important role in implementing the sanctions against Russia and Belarus adopted by the EU’. In this respect, it is noteworthy that the ECB’s stance concerning the international role of the euro shifted considerably over time. In the first decade after the establishment of EMU, the ECB and the Eurosystem advocated a policy of neutrality towards the international role of the euro (see, for example, Cohen 2011; Germain and Schwartz 2014; McNamara 2008). This position ‘reflected two differing views – one that emphasised the economic benefits of international currency status, and another that emphasised the costs. Two decades on, the balance between these benefits and costs has shifted’. Thus, the ECB came to promote ‘the euro’s global standing’ (Panetta 2020; similar issues mentioned in interview 5).

Overall, the decision to involve central banks in the financial sanctions against Russia, including the freezing of accounts of the CBR, implies roping the ECB and the Eurosystem into foreign policy-making. The ECB and national central banks have accepted this task as if it was a mere legal instruction by the Principal (the political authorities) and executed it without question as agent. In so doing, the Agent has put its primary objective on the back-burner, making it a second-order objective.

Conclusion

In this article, we set out to examine the role of the ECB and the Eurosystem in financial sanctioning against Russia, in particular, the freezing of the foreign reserves of the CBR. Drawing on the Principal-Agent theoretical framework, we explored in what way these financial sanctions may challenge meeting the primary objective of the ECB as an agent as well as affecting its relations with the political principals. With reference to the first point, we observe that there has been a *de facto* rebalancing of the stated objectives of the ECB, which has focussed less firmly on price stability (primary objective) and has favoured a broader set of objectives, including geopolitical considerations. Price stability for now has not been centre-stage; dealing with the war has been accepted as an objective that the Principal has been involved with in first instance and asked the Agent to execute. Whether or not executing the sanctions might undermine the primary objective of the ECB in any significant way, will only be known in the medium-run – perhaps only in the long-run. With reference to the second point, using the financial system as a weapon of warfare might possibly backfire. The (geo)politicisation of the financial system

could potentially in the long-run undermine the existing system if some players choose to diversify and use other systems instead.

Notes

1. The ECB with the national central banks of *all* the EU member states is referred to in the Treaty as the European System of Central Banks (or ESCB). The mandate of the ECB is stipulated in the Treaty on the Functioning of the EU and mentioned as part of the ESCB. Therefore, the delegation of competences to the ECB and the national central banks of the EU member states is treaty-based and may be further complemented by legislative acts (such decisions or regulations).
2. In July 2022, Croatia has been approved to join the euro area on 1 January 2023.
3. Some scholars (Schulz and Verdun 2022) have also examined the institutional design of the ECB, building on other studies that analysed the early years of the ECB (see inter alia, Howarth and Loedel 2005; Quaglia 2008) as well as central banking in Europe in a comparative perspective (Dyson and Marcussen 2009).
4. Swap lines are liquidity lines between central banks intended to ease tensions in international funding markets. They enable a central bank to receive currency issued by another central bank in exchange for some form of collateral.
5. Majone however points to some limitations of the Principal-Agent approach when studying the establishment and policy-making of the ECB and adds that one needs the fiduciary principle for good governance given that the ECB's 'open and broad objectives ... cannot be specified in sufficient detail'. (Majone 2001a: 72).
6. Article 129 (1) 'The ESCB shall be governed by the decision-making bodies of the European Central Bank which shall be the Governing Council and the Executive Board; (2) The Statute of the European System of Central Banks and of the European Central Bank (hereinafter referred to as 'the Statute of the ESCB and of the ECB') is laid down in a Protocol annexed to the Treaties'.
7. By contrast, this clarity of objective was lacking for the other competences that were formally and informally delegated to the ECB and its national central banks over time. It was even more so for the tasks that were taken over by the ECB itself out of its free will (e.g. its role in the Troika) or out of necessity due to inaction of the member states (saving the euro and responding to crises). Hence, in these instances, there is a potential for agency loss and agency slack.
8. In fact, the European Commission describes economic and financial sanctions as 'an essential tool in the EU's common foreign and security policy, through which the EU can intervene where necessary to prevent conflict or respond to emerging or current crises', https://finance.ec.europa.eu/eu-and-world/sanctions-restrictive-measures/overview-sanctions-and-related-tools_en
9. The BIS also adopted those sanctions, though explaining that "[Our] policy is that the institution does not acknowledge or discuss banking relationships. The BIS will follow sanctions, as applicable."

10. <https://www.worldometers.info/gdp/gdp-by-country>.
11. Russia has opted to store all of its gold domestically. Not all central banks do so: the German Bundesbank, for instance, has a third of its gold in the US, a smaller amount in the UK and very small share in France; the Dutch central bank has one third of its gold in Canada; one third in the US and one third is held domestically (<https://investingnews.com/daily/resource-investing/precious-metals-investing/gold-investing/top-central-bank-gold-holdings/>).
12. We wish to thank a reviewer for helping us to clarify this passage.
13. At the end of February 2022, Elvira Nabiullina, Governor of the CBR, stated that ‘the central bank today increased its key rate to 20% as new sanctions triggered a significant deviation of the rouble rate and limited the central bank’s options to use its gold and foreign exchange reserves,’ reported in *Reuters*, 28 February 2022, available at <https://www.reuters.com/markets/europe/russian-central-bank-scrambles-contain-fall-out-sanctions-2022-02-28/>
14. We wish to thank a reviewer for helping us to clarify this point.
15. Council Regulation (EU) 2022/334 of 28 February 2022 amending Council Regulation (EU) No 833/2014 concerning restrictive measures in view of Russia’s actions destabilising the situation in Ukraine. *Official Journal of the European Union* 28.2.2022, L57/1. ‘EU member states that have not yet adopted the euro have access to the decision-making process through their ministers of foreign affairs. These, in turn, may consult with their national central banks before making decisions (unless there are time constraints in decision-making).
16. Council Regulation (EU) 2022/334 of 28 February 2022 amending Council Regulation (EU) No 833/2014 concerning restrictive measures in view of Russia’s actions destabilising the situation in Ukraine. *Official Journal of the European Union* 28.2.2022, L57/1. ‘Transactions related to the management of reserves as well as of assets of the Central Bank of Russia, including transactions with any legal person, entity or body acting on behalf of, or at the direction of, the Central Bank of Russia, are prohibited’.
17. For instance, as one of our interviewees explained, as the majority of countries blocks one or more countries from SWIFT, messages start to be sent via other systems.
18. We wish to thank a reviewer for encouraging us to elaborate upon this point.

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Lists of interviews

This article benefitted from six semi-structured interviews that were held between July-December 2022.

1. 28 July 2022 interview with a leading finance expert with connections to the French government, EU policy-making, and US policies in this domain
2. 8 December 2022 interview with a European Union policy maker involved in policy-making surrounding sanctions (both Council and Commission)
3. 22 August 2022 interview with two leading financial experts, one of whom has worked to advise the US government on these kinds of issues
4. 20 September 2022 interview with a high-level ECB official responsible for banking policies
5. 8 November 2022 interview with a high-level official associated with the Belgian Central Bank, familiar with international matters such as BIS and ECB
6. 16 November 2022 interview with a high-level ECB official involved in international matters

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