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Russia’s ban from SWIFT: an advantage for China

Including the payment information system in sanctions against Russia will further accelerate the development of alternatives, in favor of China

In the context of Russia's invasion of Ukraine, the ban of Russian banks from SWIFT (“Society for Worldwide Interbank Financial Telecommunication”) is among the most discussed – and at times arguably symbolically exaggerated – economic sanctions. As I have already argued, many contributions to this discussion are subject to a serious misunderstanding. SWIFT is not a payment system, but “just” a payment information system. Prior to SWIFT, the payment information was typically communicated by telex, an infrastructure that continues to exist but is far more cumbersome, slow, and insecure, much like fax or e-mail.

Underlying SWIFT as the payment system for international transactions is the network of correspondent banks that hold accounts with each other, particularly for the clearing and settlement of cross-border payments. At the national or European level, separate systems for these functions often exist, in the EU TARGET2 or SEPA, in the U.S., for example, CHIPS (Clearing House Interbank Payments System).

The “nuclear option” vis-à-vis Russia is not an exclusion from SWIFT (alternative means of communication could still be used here to some degree), but a ban on Western correspondent banks from continuing to conduct transactions with Russian banks. This is especially true if this ban is not limited to individual Russian banks and does not include exceptions (for example, for food, gas, and oil).

Secondary sanctions on third-country banks have a greater effect

The nuclear option is most effective when governments impose corresponding bans not only on domestic banks but also, as “secondary sanctions”, on banks in third countries. The U.S. regularly impose such secondary sanctions, which have serious global consequences, as larger banks are dependent on US authorization due to the central role of the dollar and the US financial system, and therefore almost invariably comply with US sanctions.

The European economy rightly fears a ban on any relations with Russian banks. A comprehensive implementation of this ban would severely impede both the payment of energy imports from Russia and the payment of European exports (for example machinery) by Russian importers. As a result, trade with Russia could be put on hold, at least temporarily. Moreover, the repayment of outstanding loans by Russian companies to European banks could then come to a standstill, and European foreign investments in Russia would be on the brink of collapse.

Justified as these immediate concerns may be for the banks and companies involved, far more serious consequences for the global financial system loom in other respects. Excluding Russia from the SWIFT-supported payment system formed by correspondent banks – and even simply discussing this option – will lead to states such as Russia and China further intensifying their activities to build alternative systems.

Russia’s payment information system is technically limited

My recent pre-print review of Sino-Russian initiatives to establish cross-border payment infrastructures, which was conducted as part of the DFG-funded StateCapFinance project, shows that the process of establishing these infrastructures has already advanced significantly over the past ten years. This development was set off by sanctions against Iran, which as of 2012 also included SWIFT, to close the last loopholes for Iranian banks following previous U.S. secondary sanctions. Again, the exclusion from SWIFT did not serve as the “atomic bomb”, but rather as the “icing on the sanctions cake”.

However, the inclusion of cross-border payment systems in sanctions against Iran and calls for their inclusion in sanctions against Russia following the 2014 occupation of Crimea have prompted Russia to develop its own SPFS payment information system in the meantime. This system runs parallel to SWIFT and could replace the latter for many transactions in the event of sanctions, albeit with much more limited technical capacity.

China’s alternative system is likely to become much more relevant than its Russian counterpart in the future. This also applies to the circumvention of financial sanctions against Russia if the Chinese government tolerates the latter. The Chinese Cross-Border Interbank Payment System (CIPS) does not only contain an information system (like SWIFT), but also a ready-to-use system for clearing and settling payments.

China plays a leading role in the development of digital central bank currencies

Even though the volume of payments processed via CIPS is still limited (for example, compared to the U.S. domestic CHIPS), the number of connected participants is exploding, for example, from 195 in October 2015 to 1189 in May 2021. The current discussions on the correspondent banking system and SWIFT as a sanctioning tool against Russia will accelerate this process.

However, this global payment system, which has hitherto been under Western control, is likely to face an even greater long-term challenge from the establishment of digital central bank currencies. This is especially true when they are being connected within a system, as in the current “mBridge” project. Such central bank currencies bypass the banking system - and with it the system of correspondent banks and SWIFT.

In the development of digital central bank currencies, China plays a leading role on a global scale, especially with the rapid establishment of the digital renminbi. However, this role is even more important in the development of a multi-central bank currency system. The underlying assumption is that many traders and investors will continue to view the digital renminbi as “toxic” for the foreseeable future. The latter would be put into perspective, however, if it were possible to switch to other digital central bank currencies without friction within the framework of such a system. This would bring China much closer to its long-term goal of eroding the U.S. dollar as a global trade and reserve currency.

In the long term, the future of the established global financial system is at stake here. Until now, this system has been based on the dominant role of the U.S. dollar, the U.S. financial system, and centralized infrastructures under Western control such as SWIFT. The use of such infrastructures as a sanctioning tool has unintended consequences. In the long run, it may not only weaken the global financial system, but also the supremacy of the United States. The latter is based not least on the exorbitant privilege of the dollar, which is an important basis for permanently financing the serious U.S. current account deficit.

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