

## **02 CHAPTER**

# **New Data on the Effects of Sanctions Targeting States**

What are policy leaders to make of the enthusiasm for the targeted sanctions implemented in the last 15 years on the one hand, and some of the concerning critiques about their effects and utility on the other?

What lessons are they to draw about when sanctions, an increasingly integral element of U.S. security strategy, work and how to contemplate the costs and benefits of using them? These questions are central to the defense, security, and commercial communities. However, the policy discussion of such questions suffers from inadequate empirical analysis.

As a contribution to the policy debate about the role of sanctions, and to test some of the contemporary claims and counterclaims regarding the use of U.S. economic sanctions since the September 11 terrorist attacks in 2001, we conducted original quantitative research on the effects of sanctions. We chose to evaluate states targeted by sanctions and compiled a data set that compares such countries with “peer economies” that share similar regional, economic, and political profiles. Each sanctioned country then was compared with its peer group to see if sanctions imposition has significant effects on the target’s economy and polity. We designed this methodology, which is discussed in detail below, to help contemporary scholars and practitioners evaluate a much-lauded policy instrument, which is often deployed as a first resort against adversary governments. While the use of sanctions to target non-state actors like transnational organized crime networks or cells of terrorists, narco-traffickers, and proliferators is also commonplace, it is not the subject of the data analyzed in this chapter. We focus instead on states, given the availability of data and the relevance of this unit of measure in an international political milieu defined overwhelmingly by great power competition and state-based competition. Key findings of our study are listed below.<sup>54</sup>

## New Findings on the Effects of 21st-Century Sanctions

The results of our research are clear:

- Sanctioned countries do not suffer significant costs as measured by lost economic growth or greater inflation;
- Sanctioned countries *do* face significantly elevated levels of political risk, depressing investment in the target’s economy;
- Sanctioned countries experience significantly higher levels of corruption; and
- Sanctions affect the governance of target countries.

These results help to explain the persistent debate over the efficacy of sanctions. On the one hand, targeted economic sanctions clearly have potent effects on the economies of target states. On the other hand, the extant concerns raised about the negative externalities of coercive economic measures are valid. Sanctions contribute to higher levels of economic corruption and lower levels of investment in the targeted states.

The results also have implications for the development of strategies suggesting when sanctions should be deployed and when they will be most effective. This is because the data suggest that the types of financial sanctions that have been deployed against states in the last two decades should have a greater impact on the decisionmaking of states for which attractiveness to international trade and investment is strategically significant. The theory of compellance dictates that in order to achieve the desired results, a state must manipulate the cost/benefit calculations of its target such that the target of the compellant actions is motivated to abandon its chosen course of action.<sup>55</sup> States for whom foreign trade and investment is important are more likely to be impacted than those (like North Korea) that rely very minimally on external financial relationships for their economic well-being. These kinds of sanctions programs should identify those features of a target’s economic or commercial life that are most significant to the country or its leadership and design measures to target those interests directly.

The development of the Ukraine/Russia *sectoral sanctions* program in 2014<sup>56</sup> is one example of this strategy at work. In response to Russian aggression in Crimea and eastern Ukraine, the United States and European

Union imposed sanctions that made it harder for Russian banks and energy companies to issue equity and/or debt with a maturity longer than 30 days.<sup>57</sup> This measure was designed with these companies' significant exposure to U.S. and European capital markets and their extensive need for medium-term financing in mind. Significantly, it did not directly target the market for overnight lending to these companies, which might have effectively put them out of business (and had even more substantial side effects for their counterparties in Western European and North American financial markets). The sanctions also reduced the ability of Russian energy companies to secure energy technology, equipment, and services from the United States and the EU, effectively making partnerships with the world's most sophisticated and adept energy companies impossible for energy development in locations that are difficult to access, like the Arctic.

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The sectoral sanctions therefore effectively identified the interests that were important to the Russian leadership and targeted those interests with as much precision as possible. Additionally, the sanctions were chosen to maximize the effect on Russian entities while limiting effects on other countries or companies with which Russia trades and banks. While Russia has not reversed its annexation of Crimea or removed its weapons or fighters from eastern Ukraine, the situation has stabilized somewhat since the signing of the Minsk II agreement, and the Kremlin's initial stated objectives – such as establishing Russian control over large swaths of Ukrainian territory (the “Novorossiia” project) – were abandoned.

Determining the effectiveness of this particular set of sanctions measures (and many others as well) is difficult as it depends fundamentally on a counterfactual that can never be proven – what would President Putin have done if the sanctions had not been imposed? While it is possible that he was contemplating more aggressive measures in Ukraine from which he refrained because of fears of more comprehensive sanctions, it is unlikely that the public record will ever definitively resolve that question. Nevertheless, in the Russia case the United

States and Europe designed a sanctions program with unprecedented precision, albeit with non-trivial side effects (explored below in greater detail). The Russia sanctions also marked the first time the United States and the EU created a sanctions program collaboratively from the start.

The point can be generalized. In much the same way as the trajectory charted above illuminates a path of increasing precision, the future of sanctions – both the effectiveness and legitimacy of the instrument – depends on increasing the proximity of the link between interests that the sanctioned country values and the means chosen to target those interests. The tools available to the United States and allied governments are broad. The main statute structuring the U.S. government's sanctions programs gives it authority to “investigate, regulate, or prohibit” a broad range of financial transactions in response to national security emergencies.<sup>58</sup> In the future this authority can – and should – be deployed with ever greater creativity and precision.

**The Testing Strategy**

To test the effects and effectiveness of 21st-century coercive economic measures, we gathered data on all instances in which the United States initiated economic sanctions since September 11, 2001.<sup>59</sup> Twenty-two sanctions cases were culled from three different sources: Rice University's Threat and Impositions of Sanctions (TIES) dataset, the Petersen Institute for International Economics (PIIE) dataset of 21st century cases, and the U.S. Treasury Department's OFAC sanctions website. The cases are listed in Table 2 in the appendix.

To code the outcomes of these 22 cases, we relied on the codings from the TIES and PIIE data sets that were available. There were still 13 cases that were ongoing, or in which significant developments justified taking another look at the effectiveness of sanctions. To code these outcomes, we surveyed more than 80 sanctions experts and asked them to code the success of recent cases. We received 25 responses, or a 30 percent response rate.

Combined, Table 2 shows that there were nine successful outcomes out of the 22 sanctions cases, or a 40.9 percent success rate. This is significantly higher than Robert Pape's very pessimistic 5 percent success rate, or the more generous 33 percent success rate calculated using Hufbauer, Schott, and Elliott's pre-1990 set of

sanctions cases.<sup>60</sup> At a minimum, it would appear that the policymaker enthusiasm for 21st-century coercive economic measures is somewhat justified.

To examine the effects of 21st-century economic sanctions on targeted economies, we adopt a methodology that the U.S. Government Accountability Office employed to assess the effect of U.S. sanctions on the Iranian economy.<sup>61</sup> Their approach “identified a group of peer economies, which helped ... to isolate economic changes that are unique to Iran but not necessarily to identify the impact of sanctions.”<sup>62</sup> The idea is to ensure that the imposition of economic sanctions, rather than other factors, is responsible for changes in the target economy and polity. For example, as the case of Russia makes clear, the imposition of sanctions in 2014 hurt the Russian economy. Even more painful to Moscow, however, was the collapse in oil prices in the fall of 2014, an event that was unrelated to sanctions. Since that effect was more pervasive than just on the Russian economy, it should be reflected in the changes in Russia’s peer group.

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We have adapted that approach to our data set. For each instance of sanctions imposition, we searched for countries with similar economic size, trade portfolio, and regional proximity. For each sanctions episode, five peer countries were identified. Table 3 (in the appendix) lists the peer countries.<sup>63</sup>

We examine how well the sanctioned country performed across a wide range of economic and political measures, listed in Table 4. After selecting the cases and the peers, we collected data on the relevant economic and political indicators. We then compared whether the targeted country performed differently than its peer group after sanctions were actually imposed. To measure the staying power of economic sanctions, we conducted difference of means tests comparing the economic and political measures before sanctions imposition to how these countries fared the first year under sanctions, and then the third year under sanctions.

As Table 4 (in the appendix) shows, measures of economic performance include GDP growth, inflation, investment, imports, exports, and the current account balance. These data were obtained from the International Monetary Fund (IMF) for every year between 2001 and 2014.

The next set of indicators came from the Political Risk Services (PRS) group, a subscription-based service that provides data on foreign investment and country-specific political and economic factors.<sup>64</sup> PRS offers a welter of measures for possible risk factors for foreign investors. Annual data for both the targeted and peer countries was collected for the level of civil disorder, corruption, economic risk, financial risk, political risk, aggregate risk, government stability, popular support, risk for GDP growth, risk for inflation, risk for international liquidity, and socioeconomic conditions. The PRS data coverage is less comprehensive than the IMF, as it focuses much more on emerging market economies. Nevertheless, the coverage is still sufficient to run the necessary difference of means tests.

The Worldwide Governance Index (WGI) from the World Bank was used for six indicators: control of corruption, government effectiveness, rule of law, regulatory quality, political stability, and the absence of violence and voice and accountability. The WGI index was not available for the years 2001 and 2014, the first and last years of our study, but the rest of the years were available.

A final set of sociopolitical indicators were collected from multiple sources. Polity IV was used for annual polity scores – the measure of whether a regime is democratic or authoritarian in nature. The Human Development Index (HDI) was collected from the U.N. Development Program. The HDI was not available on an annual basis until 2008. Before 2008, data was available for the 2001 and 2005 years. In order to fill in the missing data, we interpolated a simple linear progression between 2001 and 2005 and between 2005 and 2008 and imputed the difference between the two over the missing years. Finally, for one final check on corruption in addition to the PRS and World Bank measures, we drew from the Corruption Perception Index from Transparency International for all the years under analysis.

## The Statistical Results

Tables 5, 6, and 7 (in the appendix) show the effects of sanctions imposition on the target country's economy and polity. Table 5 looks at the IMF measures of economic performance. It offers a mixed picture on the effectiveness of 21st-century sanctions at inflicting economic pain. On the one hand, there is no evidence that the imposition of sanctions affects the most obvious economic measures. The effect of sanctions on economic growth was predicted to be negative. Instead, sanctions are correlated with stronger growth relative to the target's peer economies, though this result is not statistically significant. Similarly, the effects on inflation, imports, and exports are all statistically insignificant as well. These results hold for both the one-year and three-year mark, so it is easy to see why some observers would infer that sanctions are ineffective in inflicting costs on the target economy.

Still, there are two significant and direct effects that economic sanctions have on target economies. First, the target's current account deficit is more likely to increase. Second, and more significantly, the imposition of sanctions causes investment to lag dramatically. These results are significant at the 0.1 percent level and hold at both the one-year and three-year mark. Intuitively, this is unsurprising; one would expect both domestic and foreign investors to be more risk-averse in the face of economic sanctions. So it would seem that the causal mechanism through which 21st-century sanctions impinge target economies is through deterring investment.

Table 6 shows the effect of sanctions on the political risk variables, which buttress the finding that economic coercion affects political risk, which in turn depresses investment. The imposition of sanctions does not have a significant effect on either civil disorder or aggregate government stability. Sanctions have a pronounced and significant effect on all of the perceptions of risk, however. Economic risk, financial risk, political risk, risk to GDP growth, and risk for international liquidity all go up for countries facing coercive economic measures. These are all significant at the 1 percent level. Given these findings, it is unsurprising that the composite risk rating also goes up in response to sanctions imposition. Sanctions have a negative and significant effect on the target country's socioeconomic conditions. Somewhat surprisingly – and in contrast to numerous “rally round the flag” arguments with respect to economic coercion – sanctions also have a negative and significant effect on popular support for the target regime.<sup>65</sup>

These results are interesting in light of the finding that sanctions do not appear to have a significant effect on GDP growth but do have a significant impact on investment. There are two possible – and not mutually exclusive – explanations for these findings. The first is that while modern sanctions might not have appreciable economic effects, the PRS variables are measuring perceptions of risk. The imposition of sanctions elevates perceptions of economic and political risk, which in turn affects investors, which in turn affects the target government. So even if the actual impact on GDP might not be great, the perceived costs are significant.

The second explanation is that sanctions do have an appreciable impact on the target economy, but target governments can partially compensate for that effect. The significant effects of sanctions on risk perception and investment suggest that the causal chain is that sanctions lead to elevated perceptions of risk, which leads to reduced investment. Governments can respond to this with greater fiscal spending or by subsidizing private consumption. Either of these actions can forestall lower rates of GDP growth for a few years.

### ***The causal mechanism through which 21st-century sanctions impinge target economies is through deterring investment.***

At the same time, such actions are not costless. The effect of sanctions on socioeconomic conditions and regime support further suggests that enduring sanctions generate negative political and economic effects that the target regime must consider. This is particularly true if the target relies on foreign trade and investment – or intends to do so as a way to boost economic growth.<sup>66</sup>

Twenty-first-century sanctions have significant effects on target economies and economic perceptions about the target country. What about negative externalities? A key argument made about modern sanctions is the precise nature of the sanctions tool – modern sanctions should have fewer deleterious effects than the trade sanctions of yesteryear. Table 7 examines the effect of sanctions on a host of sociopolitical factors. The results strongly suggest that 21st-century sanctions still have many negative second-order effects on the target country. All of the indicators suggest that sanctions may contribute to more autocratic forms of governance. The

Polity score, as predicted, moves in a more authoritarian direction, and is significant at the 0.1 percent level. At the same time, the World Bank measures of political stability, voice and accountability, government effectiveness, and regulatory quality all decline appreciably in the target countries, although the effect on political stability measure is insignificant after three years. Nevertheless, the aggregate effect of sanctions may move target regimes in a less democratic direction.

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Given the effect of sanctions on the target economy, this is not entirely unsurprising. Some scholars argue that as an authoritarian regime faces greater financial constraints, the ruling government will opt for repression over rewarding key members of the selectorate as a tactic for staying in power.<sup>67</sup> By definition, sanctions are designed to place such restrictions on the target government. It is therefore possible that even targeted financial sanctions are *more* likely to trigger repression. In other words, sanctions make authoritarian governments act in an even more authoritarian manner.

Another clear effect from these results is that 21st-century economic sanctions have a powerful effect on corruption in the target economy. Three different measures of corruption were used: the PRS corruption ranking, the Transparency International corruption perceptions index, and the World Bank's measure of control of corruption. All three measures trend in the predicted direction and are statistically significant after one year and three years. These three corruption measures were developed independently of each other; that all three are significant suggest the robustness of this particular finding.

Finally, sanctions also have a negative effect on the U.N.'s Human Development Index. Compared to peer economies, a sanctioned economy lags on this measure. Given the statistically significant effects previously discussed, this should not be too surprising. Sanctioned economies suffer from a lack of investment, an elevated perception of risk, more authoritarian regimes, a lower quality of government, and more corruption. Combined, it should not be too surprising that these would have a negative impact on human development more generally.

These sobering results make clear to any doubters that the use of sanctions does not come without costs. Furthermore, policymakers may take from this exposition that they would be wise to dedicate serious resources to rigorously modeling and anticipating the potential economic and political costs of sanctions before they impose them in order to determine when the acceptance of these costs will be in the broader U.S. interest and when it will not. To make such a policy evaluation, however, it is useful to fundamentally focus on the issue of sanctions effectiveness – that is, the value sanctions offer to advancing U.S. policy interests in whole or in part. Elevating this consideration in the decision of whether to undertake sanctions will make policy leaders more clear-eyed and better aware of their leverage points and vulnerabilities. Additionally, and usefully, it may motivate successive technical innovations in sanctions to achieve yet more narrowly focused targets and effects, and more transparent and transactional terms for the sanctions' quid pro quo to better compel rogue states to change their behavior and be freed of sanctions.

### **Case Studies of Effectiveness**

In order to consider the issue of the effectiveness (rather than just the effects) of sanctions, we examined several sets of sanctions case studies. The following cases examine high-profile instances of U.S.-led sanctions and are associated with key current and future U.S. security concerns. The cases include sanctions imposed over nuclear proliferation (Iran), territorial aggression (Russia), civil war (Syria), and political repression (Venezuela). Ultimately, we chose them for their political relevance to current and future policy leaders, prominence in scope and significance among the various sanctions regimes of the last 15 years and for the diversity of policy concerns they encompass.

In our analysis, the criteria for effectiveness of U.S. sanctions are the following: (1) the ability to meaningfully shape the political environment and balance of political leverage, including through changed economic circumstances; (2) catalyzing relevant communities (domestic or international) to concerted action, including by messaging with respect to sanctions targets; and (3) achieving discrete, high-level political objectives in support of overall U.S. policy goals. Our definition of sanctions effectiveness is predicated on the notion that sanctions alone generally cannot change regime behavior and must be used and evaluated along with

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other tools of national power, such as military force, diplomacy, cyber capabilities, and intelligence activities. Furthermore, all three criteria for effectiveness may not be present in every case. Determinations of effectiveness need not mean that sanctions have no negative economic or political effects on the target, the international financial system, or the United States. As discussed, sanctions are almost never a costless policy tool; the question is whether on balance they are likely to do more good than harm.

Moreover, there is no generalizable timeline for measuring the effects and effectiveness of sanctions – each case embodying different objectives must be taken on its own terms. A challenge in looking at sanctions of the last 15 years is the relatively recent timeframes in which many targeted sanctions have been implemented and the tendency of targeted sanctions to have a lagged effect on economic output. This also may help explain the apparent limits of sanctions’ ability to coerce changes in political behavior in the short term. Over the longer term, however, a clearer picture may begin to emerge.

#### **IRAN: NUCLEAR PROLIFERATION**

U.S. foreign policy has restricted trade with the Islamic Republic of Iran since 1979, and some Iranian assets in the United States have remained frozen since the hostage crisis. The designation of Iran as a “state sponsor of terrorism” allowed the United States to impose a broader set of sanctions against the regime, including a ban on direct financial assistance, withholding of payments to countries or organizations that provided assistance to Iran, and a requirement to vote to oppose multilateral lending. In 1996, Congress passed the Iran-Libya Sanctions Act (ILSA, later modified to become the Iran Sanctions Act or ISA), which placed restrictions on major investments in Iran’s petroleum industry. However, Iranian oil exports retained their access to world markets, enabling the regime to continue selling the commodity and allowing the country to run a sizeable trade surplus due to dollar-denominated export earnings. Testifying before Congress on the results of the sanctions, Jeffrey Schott said, “Simply imposing costs on the target country may satisfy a thirst for retribution, but it does not necessarily promote the achievement of U.S. foreign policy goals.”<sup>68</sup>

After 2002, when evidence emerged that Iran was developing uranium enrichment capability, the United States attempted to restrict the growth of Iran’s nuclear program by dramatically increasing the scope of targeted economic sanctions. But it wasn’t until the 2007–2010 period that the use of targeted sanctions became the core of U.S. policy toward Iran.<sup>69</sup>

In 2010, the United States passed into law the Comprehensive Iran Accountability, Sanctions, and Divestment Act (CISADA). This expanded on the ISA, establishing broad new limitations on Iran’s energy industry and on financial transactions with Iranian institutions. The new law prohibited U.S. banks from maintaining correspondent accounts for foreign financial institutions that facilitate transactions for the Army of the Guardians of the Islamic Revolution (IRGC) or its affiliates, and that engage with designated Iranian banks. Following the implementation of CISADA, a series of statutes and Executive Orders issued through 2012 imposed secondary sanctions on those foreign entities that engage in business with sanctioned Iranian entities and further blocked Iranian access to the international financial system. In parallel to this tightening of U.S. sanctions, and after the adoption of UNSCR 1929, the European Union expanded its own Iran sanctions regime and with time instituted an embargo

on Iranian oil imports, increased targeted sanctions on financial ties with the Central Bank of Iran, and prohibited specialized financial messaging between institutions of its member states and designated Iranian financial institutions. Considered collectively, the variety of targeted financial measures levied by various jurisdictions against Iran amounted to a relatively broad multilateral trade embargo spanning a huge variety of Iran's economic activity.

The new sanctions proved far more effective than the previous restrictions on Iran, adversely impacting economic growth within short order. Consistent with our statistical findings, the targeted sanctions limited investment in Iran's oil sector. They also significantly raised the degree of difficulty of selling (and receiving payment for) its oil exports. Oil exports dropped from 2.5 million barrels per day (bpd) in 2011 to 1.1 million bpd in 2013; EU imports fell from approximately 600,000 bpd to effectively zero, and Iran's oil exports to OECD and non-OECD Asian countries (China, India, South Korea, and Japan) dropped by more than 525,000 bpd.<sup>70</sup> Although it continued to export oil to other buyers, Iran was barred from accessing most hard currency held in foreign accounts.<sup>71</sup> By 2013, Iran's oil minister acknowledged that falling exports were costing the country between \$4 and \$8 billion per month.<sup>72</sup> In an attempt to boost revenues, Iran sought new payment mechanisms, moving away from its traditional trading relationships with Europe and Russia and relatively closer to Turkey and the United Arab Emirates.<sup>73</sup>

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*The promise of sanctions removal was the principal motivation for Iran to strike a deal during the Joint Comprehensive Plan of Action (JCPOA) negotiations. In Lausanne, Switzerland, negotiators representing the P5+1, EU, and Iran agree on parameters for a JCPOA in April 2015. (U.S. Department of State/Flickr)*



The financial restrictions were so comprehensive that the Society for Worldwide Interbank Financial Telecommunication (SWIFT) was forced to bar from its system all transactions of Iranian banks named in the EU sanctions. According to U.S. Treasury Secretary Jacob Lew, these restrictions, combined with falling oil production, caused economic growth in Iran to fall by 9 percent over 2012 and 2013.<sup>74</sup> The restrictions also contributed to a drop in the value of the rial, rising Iranian inflation, growth in unemployment to approximately 20 percent, and a troubling increase in non-performing loans at Iranian banks.<sup>75</sup>

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Despite the aforementioned criticisms regarding the ability of targeted sanctions to achieve political change, their use in Iran appears to have had at least some effect on the political system. Most notably, relatively moderate cleric Hassan Rouhani was elected president in 2013 after running on a platform of easing sanctions and ending Iran's international isolation following the two terms of his controversial predecessor, Mahmoud Ahmadinejad. Upon taking office, Rouhani publicly acknowledged that the effect of sanctions on the Iranian economy was severe and required quick negotiations to settle the nuclear question.<sup>76</sup> As Iran's subsequent negotiating behavior during the JCPOA suggests, the principal motivation for Iran to strike a deal was the promise of sanctions removal.

At the same time, however, conservative elements of Iran's government have been willing to act in a more repressive manner since the imposition of targeted financial sanctions. The regime suppressed a brief renewal of the Green Movement in early 2011. More intriguingly, repressive activities may have increased since completion of the nuclear agreement in July 2015. *The Wall Street Journal* recently reported that, "Tehran security forces, led by Supreme Leader Ayatollah Ali Khamenei, have stepped up arrests of political opponents in the arts, media and the business community."<sup>77</sup>

On balance, however, given the success of the international community in pursuing diplomacy to exact substantial nuclear concessions from Iran in exchange for relief from financial sanctions pressure, sanctions in the Iran case were demonstrably effective. Their imposition did compel behavior change by the Iranian regime and incentivized it to reach a deal that included substantial concessions on Iran's nuclear program. Through the economic pressure it generated, and the platform it provided for consistent and coordinated multilateral messaging, we judge the nuclear agreement of 2015 as a sign of Iran sanctions' success (even if it is impossible to say at this point whether the deal will decisively and permanently resolve the international community's concerns regarding Iran's nuclear program). This judgment also does not minimize the existence of other factors (such as pervasive corruption, economic mismanagement, and a low oil price) that may have contributed to Iran's economic woes. But it does offer a persuasive example of the effectiveness of sanctions in compelling change in line with U.S. interest on Iranian proliferation matters.

## RUSSIA: TERRITORIAL AGGRESSION

In response to the annexation of the Crimean Peninsula by the Russian Federation in March 2014, President Obama issued three executive orders that provided the Treasury and State Departments with broad authority to impose sanctions on Russian individuals and companies. Initially, the U.S. government used these authorities to sanction close associates of President Putin and individuals involved in undermining Ukraine's democracy. When the crisis worsened in the summer, the United States expanded restrictions to encompass sectoral sanctions, imposing targeted restrictions on Russia's banking, energy, and defense sectors. Following the downing of Malaysia Airlines Flight 17 on July 17, 2014, the EU followed suit and imposed sectoral sanctions of its own. When Russia doubled down and launched a full-scale invasion of eastern Ukraine in August 2014, the United States and the EU imposed another round of sectoral sanctions in September. Through the use of these sanctions, the United States and the European Union sought to deter Russia from further aggression and to compel Russia to respect Ukraine's sovereignty by making it more difficult for Russia to finance its economic development.

The main areas targeted by the sanctions were the energy, defense, and financial services sectors. Four state-owned energy companies were named as targets of the sanctions, and U.S. companies were restricted from providing technology, equipment, and services used to support exploration or production from deepwater, Arctic offshore, or shale oil projects.<sup>78</sup> In addition to hindering energy production, the sanctions restricted Russian access to the international financial system, particularly to U.S. and European capital markets. Further, individuals deemed to be "materially or financially supporting actions undermining or threatening Ukraine's sovereignty, territorial integrity and independence" or "benefiting from the annexation of Crimea or the destabilization of Eastern Ukraine" were subject to travel bans and asset freezes. These individuals included several large shareholders in Bank Rossiya, which has close ties to a number of Putin's political allies.<sup>79</sup> When Russia's largest financial institution, Sberbank, was added to the list of sanctioned entities in September 2014, former board member Sergei Guriyev predicted that the sanctions could raise borrowing costs for Russian banks in non-Western markets.<sup>80</sup>

According to the IMF, Russian GDP was expected to drop by 3.8 percent in 2015, and an additional 1 percent in 2016, as a result of falling real wages, higher borrowing costs, and low consumer confidence.<sup>81</sup> Russia also has

experienced significant capital flight. OAO Megafon, a wireless operator, decided to hold approximately 40 percent of its cash in Hong Kong dollars; Norilsk Nickel, the world's largest producer of nickel and palladium, also decided to keep substantial cash in Hong Kong dollars.<sup>82</sup> In response, the Hong Kong Monetary Authority had to intervene to defend the Hong Kong dollar's peg to the U.S. dollar.<sup>83</sup> Low global oil prices are widely considered the main driver of Russia's economic downturn over the past 18 months, although the sanctions were viewed as key contributors to the recession by limiting foreign investment's ability to make up for the shortfall in oil revenues.<sup>84</sup> IMF projections over the medium term indicate that lower investment in Russia could lead to a cumulative loss of output of up to 9 percent of GDP.<sup>85</sup>

Anders Åslund of the Peterson Institute for International Economics claims that financial sanctions on Russia have been "far more severe in their effect than anyone believed," including preventing the government from borrowing to make up for the shortfall in export revenues caused by low oil prices. In order to regain access to financial assets, several wealthy and prominent individuals targeted by the sanctions have been forced to return to Russia from living abroad.<sup>86</sup> These individuals have been rewarded with additional benefits from Putin. However, this has alienated members of the local elite outside of the inner circle, and could potentially lead to further destabilization if they choose to export significant amounts of their cash outside of Russia.<sup>87</sup>



*It may be too soon to judge the effectiveness of U.S. sanctions on Russia. While there is some evidence sanctions deterred President Putin from engaging more aggressively in Ukraine, Russia also officially annexed Crimea. Russian forces are stationed at the Perevalne military base in Crimea in 2014. (Wikimedia Commons/Anton Holoborodko)*

The political situation inside Russia also has deteriorated since the sanctions were imposed. The most prominent example of this was the murder of Russian opposition leader Boris Nemtsov in February 2015. There was widespread speculation that Putin was behind the assassination.<sup>88</sup> The frenzy that surrounded Vladimir Putin's disappearance from public view in March 2015 also highlighted the regime's growing degree of centralization and fragility.<sup>89</sup>

As for the effectiveness of sanctions on Russian actions in Ukraine, to date they must be characterized as modest. On the one hand, there is evidence that sanctions deterred Putin from taking more aggressive action in the rest of Ukraine, and beginning in August 2015, Russian proxies in eastern Ukraine acquiesced to a loosely-held ceasefire.<sup>90</sup> Through the second half of 2015, Russian presence in eastern Ukraine was not reported to have accelerated in aggression and no overt provocations were observed. Additionally, Russia agreed to cancel sham separatist elections that had been scheduled for October and November although it continued to block OSCE monitors from entering the conflict areas of eastern Ukraine.<sup>91</sup>

***Financial sanctions on Russia have been far more severe in their effect than anyone believed.***

On the other hand, Russia has officially annexed Crimea, and events outside the region have raised questions about Europe's commitment to maintaining the sanctions regime. French President François Hollande spoke out against sanctions during the summer of 2015 when local producers of food and luxury goods were particularly hard-hit by losing access to markets among the Russian elite due to Russian counter-sanctions. This compounded the original effects of diminished trade and export revenue for European manufacturers from implementation of the sanctions on Russia in 2014. During a closed-door meeting of EU delegates in December 2015 to discuss the sanctions regime, Italian representatives objected to a vote on extending the sanctions, reportedly due to their own desire for a broader debate encompassing Germany's championing of the Nord Stream II pipeline. Notwithstanding the uneven European political sentiment toward Russia, the European Council voted in December to extend sanctions on Russia through the summer of 2016.<sup>92</sup> And Secretary of State John Kerry voiced confidence that the United States and the EU would remain united on sanctions until their objectives are met.

It may be too soon to judge the ultimate effectiveness of U.S. sanctions on Russia. At this point, it is challenging to distinguish how much of Russia's slightly moderated behavior in Ukraine is due to the effectiveness of sanctions in fostering a more moderated Russian stance there versus Russia's efforts to inspire a more tolerant international view, particularly from the Europeans, for its aggressive posture in Syria. Moscow certainly is trying to generate some European support for its leadership in Syria, the source of Europe's refugee crisis, and to take advantage of the potential U.S.-EU divide over Russia sanctions. Nevertheless, both the United States and the EU have voiced a commitment to compartmentalizing Ukraine and Syria policy and maintaining Russia sanctions until Moscow fully implements the Minsk agreements.

#### **SYRIA: CIVIL WAR**

The United States first designated Syria as a state sponsor of terrorism in 1979, and subsequent sanctions were implemented in 2004 for its involvement in Lebanon's political crisis. However, the most recent set of targeted sanctions was implemented in response to the Arab Spring protests and the ensuing civil war that broke out in 2011. Executive Orders 13572 and 13573, signed in May 2011, targeted high-level Syrian government officials including President Bashar al-Assad and members of his cabinet, and subsequent measures targeted the energy sector and froze government assets.

In addition to the U.S. action, the European Union, Arab League, and Turkey all have instituted economic sanctions on Syria, including travel bans and asset freezes. The European Union also banned crude oil imports, prohibited trade in precious metals, and put an embargo on equipment that could be used for surveillance of the opposition or other forms of violent repression, though it did ease several trade restrictions in 2013 to help support opposition forces.

Europe had been Syria's largest trading partner prior to the sanctions, representing between one-fourth and one-fifth of total trade, followed by Iraq and Saudi Arabia.<sup>93</sup> Because oil revenues represented approximately 20 percent of Syrian GDP, the EU ban on oil imports has had a particularly important economic effect, as Europe imported over \$3 billion worth of crude oil from Syria in 2011.<sup>94</sup> In addition to the European ban, the civil war has ravaged Syrian production capabilities from 400,000 bpd in 2010 to 25,000 bpd in May 2015.<sup>95</sup> Remaining crude oil production is effectively out of Syrian

government control, leading to a transfer of oil revenue from the government toward ISIS, who smuggle oil into Iraq and Turkey as well as supply Syrian markets under their control.<sup>96</sup> As a result, the Syrian government has little incentive to make political concessions to reverse oil sanctions as their infrastructure is significantly destroyed and some functioning oil assets are no longer in their control.

***Because oil revenues represented approximately 20 percent of Syrian GDP, the EU ban on oil imports has had a particularly important economic effect.***

Mohsin Khan and Faysal Itani of the Atlantic Council wrote that the Syrian economy was in “total disarray” by 2013 and estimated that real GDP fell between 50 and 80 percent in 2012.<sup>97</sup> Hyperinflation is also rampant, with the Syrian pound losing 80 percent of its pre-war value, while foreign currency reserves are estimated to have dropped by nearly 90 percent over the same span of time as the government spends down to make up for the drop in foreign investment. The regime continues to rely on credit lines from its allies in Tehran, Moscow, and Beijing, while Russia continues to honor contracts providing several billion dollars worth of arms and military equipment.<sup>98</sup>

The performance of the Syrian economy in the five years prior to the popular uprising had been relatively solid, but members of the country’s business elite with close ties to the Assad regime captured many of those gains.<sup>99</sup> U.S. and European sanctions have attempted to isolate the regime by disrupting links between the state and its benefactors, but these efforts have not been particularly successful. According to Rashad al-Kattan, a research fellow at the University of St. Andrews, “Most of these businessmen have substantial investments in the country that outweighed their overseas assets and commercial interests. Their inextricable connections with the ruling political elite have made them highly invested in the survival of the regime,” and therefore less concerned with the present negative returns on investment than with the potential benefits of remaining once the conflict is ultimately resolved.<sup>100</sup> Regarding the profile of these investors, David Butter of Chatham House says, “One of the questions that will need to be addressed in the future is what role members of the business elite from the Assad era could play in rebuilding the Syria economy.”<sup>101</sup>

Seemingly, sanctions in the Syria case have not been effective. They did form a rallying point for some likeminded countries to articulate concerns about the al-Assad regime, and they did impose some economic costs on Syria. However, they were never truly multi-lateral and lacked the support of the U.N. Additionally, none of the positive sanctions outcomes materially advanced the policy aim of limiting or reversing Syrian support for terrorism or President al-Assad’s brutal campaign against rebels in Syria. Nor is there substantial evidence that they created more leverage for the United States and Europe in advancing these goals. There are undoubtedly a number of reasons for the failure of sanctions to compel change on behalf of the regime. One key shortcoming in the Syria sanctions is in the design. The sanctions do not target a major asset of the regime that cannot be replaced in some fashion and therefore do not create a large amount of leverage for the United States and the EU. If the United States and the EU cannot strike more directly at the financial vulnerabilities of the Syrian regime, then perhaps sanctions are a policy tool focused more on expressing condemnation of President Assad’s policy choices.

#### **VENEZUELA: POLITICAL REPRESSION**

After the government of President Nicolás Maduro was accused of violating political protesters’ human rights in 2014, the United States approved a visa ban and asset freeze targeting officials implicated in the crackdown. In March 2015, the White House issued Executive Order 13692, establishing an asset freeze and blocking travel to the United States for seven prominent government officials: armed forces commander (and former director of the National Guard) Antonio José Benavides Torres; intelligence chief Gustavo Enrique González López; former national guard commander Justo José Noguera Pietri; prosecutor Katherine Nayarith Haringhton Padron; national police director Manuel Eduardo Pérez Urdaneta; army commander Manuel Gregorio Bernal Martínez; and the inspector general of the armed forces, Miguel Alcides Vivas Landino.<sup>102</sup>

To enact the sanctions, the Obama administration was required to declare Venezuela an “extraordinary threat to the national security” of the United States. The act of doing so proved to be a case of bad political theater. President Maduro accused the United States of hypocrisy for approving the sanctions shortly after an announcement regarding the normalization of U.S.-Cuba relations.<sup>103</sup> He also used the sanctions imposition to rail against American imperialism in front of the

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National Assembly. Outside observers agree that while the sanctions might have been justified, the political optics were awful.<sup>104</sup>

Two organizations for regional integration, the Union of South American Nations and the Community of Latin American and Caribbean States, indicated that the sanctions could make it more difficult for the United States to garner the support of other Latin American countries in calling on the Venezuelan government to respect the opposition.<sup>105</sup> And within Venezuela itself, the opposition Democratic Unity Roundtable (MUD) disapproved of the unilateral sanctions.<sup>106</sup>

Petroleum makes up the vast majority of Venezuelan exports, so falling oil prices over the past two years cast a shadow on its economic outlook: Economic growth is expected to decline by 10 percent in 2015, while inflation will average 159 percent by the end of 2015.<sup>107</sup> Poverty has also been on the rise, reaching 32.1 percent in 2013 and with an expected increase to 48 percent by the end of 2015.<sup>108</sup> The economic downturn has also led to significant consumer goods shortages, with some analysts claiming that oil prices would need to reach

\$100 per barrel to resolve the problem.<sup>109</sup> Venezuela's economy has been projected to shrink by an additional 6 percent in 2016.<sup>110</sup>

Christopher Sabatini of Columbia University's School of International and Public Affairs has said that the Venezuelan central bank requires access to hard currency in order to finance the country's high level of spending on food imports. The government has continued to maintain an overvalued official exchange rate for the Venezuelan bolívar, presenting "huge opportunities for corruption."<sup>111</sup>

The sanctions were widely derided as ineffective, as few analysts concluded that sanctions themselves created any meaningful economic effect on Venezuela and therefore did not give the United States any new leverage on Venezuela.<sup>112</sup> They did not galvanize international coordination on policy toward Venezuela, and they did inspire tremendous national support for President Maduro. However, it should be noted that the worsening economy clearly had an electoral effect that was, coincidentally, in line with the policy objective underlying U.S. sanctions on Venezuela.<sup>113</sup> The opposition MUD secured a supermajority in the December 2015 parliamentary elections, which could significantly curtail President Maduro's ability to govern by executive fiat during the second half of his presidential term, which expires in 2019.

As the case studies in this section demonstrate, determining the effectiveness of sanctions in any particular instance is difficult. It may take time and the evolution of political and economic circumstances to make a fuller evaluation of sanctions effectiveness in some cases. Some design and execution flaws are immediately clear as factors undermining sanctions effectiveness, as discussed above. A difficulty in selecting highly effective sanctions targets may underscore the reality that sanctions are not always the ideal policy tool. But difficulties in determining effectiveness in some sanctions cases do not indicate a lack of their utility generally. With a rigorous ability to select targets that can deliver material economic impact and that can coalesce international allies around a coordinated sanctions regime, sanctions can prove effective at advancing U.S. policy aims in part or in whole.



After the Venezuelan government was accused of violating political protesters' human rights in 2014, the United States approved a visa ban and asset freeze targeting officials implicated in the crackdown. At a rally against political oppression in Venezuela, an opposition protester symbolically wears chains. (Flickr/CarlosDíaz)

## **03 CHAPTER**

# **The Effects of Sanctions Against Transnational Threats**

The previous chapter discussed new ways to conceive of and gauge the effects and effectiveness of country-based sanctions programs that are designed to change the behavior of rogue regimes. This chapter shifts focus to analyze the effects and effectiveness of sanctions principally targeted at non-state actors. These include sanctions programs focused on curtailing terrorism, narco-trafficking, transnational organized criminal activity, human rights abuses, malicious cyber activities, and other similar harms.

In our survey of sanctions experts, the strongest degree of consensus was that sanctions against non-state actors were less effective than sanctions against states. A remarkable 27 out of 30 survey respondents – 90 percent – agreed with the contention that sanctions against state actors like Iran were more effective than sanctions against non-state actors like al Qaeda. This may in large measure be because it is extremely difficult to measure and quantify the effects of sanctions on non-state actors. The targets of non-state sanctions programs are engaged in criminal activity, so determining their budgets with any degree of confidence based on public sources is extremely difficult. And these groups expend enormous effort to evade official scrutiny of all kinds and must hide the size, origins, and composition of their budgets to maintain their activities.

***In our survey of sanctions experts, the strongest degree of consensus was that sanctions against non-state actors were less effective than sanctions against states.***

But it also might be that the non-state category of sanctions programs is different in emphasis from sanctions programs targeting rogue regimes. Both types of sanctions have preventive and coercive goals. But whereas sanctions programs targeted at regimes often give primacy to the compellance function of sanctions, those targeted at non-state actors tend to have denial as their primary objective. To the extent that sanctions on non-state actors are focused on coercing a change in behavior, that strategy may have the greatest impact on the ecosystem of actual and would-be supporters of those groups, rather than on the groups themselves. As previously noted, there is no “bargaining” with groups like al Qaeda. The wealthy prospective financier or facilitator who is considering providing support to the group,

however, may be a different story. He or she likely has a reputation to be concerned about, ambitions to travel across borders, and a transnational business enterprise, and so the prospect of ending up on a sanctions list may deter him/her from providing support to terrorist or narco-trafficking groups.

***An important goal of sanctions targeting transnational illicit actors or groups is to freeze them out of the international financial system as completely as possible.***

An important goal of sanctions targeting transnational illicit actors or groups is therefore to freeze them out of the international financial system as completely as possible in order to make it more difficult for them to engage in illicit behavior. This will contain particular threats that operate outside of the bounds of acceptable international behavior and make it “costlier, riskier, [and] less efficient” for terrorist groups, organized criminals, and narco-traffickers to raise, store, move, and use funds.<sup>114</sup> The preventive function of sanctions therefore exists alongside the coercive function.

Because these groups predominantly operate clandestinely, the signaling function of sanctions is also critical to understanding the effects (and effectiveness) of sanctions against non-state actors.

This role of sanctions not only serves the basic function of informing the world about the actors and operations of deadly terrorist organizations and pernicious criminal groups, but also helps shape – and sometimes shift – the public narrative about the nature of their activities.

## Intended Effects of Sanctions on Non-State Actors

Of the wide range of non-state actors, counterterrorism sanctions programs are the most broadly adopted both by nations around the world and by international organizations like the United Nations. They also are often seen as key to counterterrorism efforts to name, shame, and impede the material underpinnings of terrorist activities. In the absence of comprehensive empirical data about the effects of such sanctions programs, we can describe three main effects that sanctions against non-state actors are designed to have. The first is the denial of funds to non-state actors and their exclusion from the formal financial system; the second is to compel supporters of illicit actors to stop doing so and to deter would-be supports from becoming engaged in illicit activity; and the third is to shape the public narrative about non-state actors through the public pronouncements that typically accompany the imposition of financial sanctions.

Because terrorism sanctions are the most broadly adopted around the world, and furthermore broadly believed to be important to the counterterrorism effort, this section focuses predominantly on sanctions against terrorist groups. However, the three main categories of effects described below also are applicable to all other illicit non-state actors targeted by sanctions programs.

### EXCLUSION FROM THE INTERNATIONAL FINANCIAL SYSTEM

At their most basic level, sanctions imposed on terrorist groups are designed to deprive them of their access to funds and to the architecture of the international financial system used to move and store money. In the United States, the establishment of a financial sanctions program specifically directed at terrorist financing was one of the “first strike[s] on the global terror network” that the U.S. government took after 9/11.<sup>115</sup> The explicit purpose of the sanctions program was to “starve” terrorist groups of their funds,<sup>116</sup> and it froze assets that designated persons held in entities subject to U.S. jurisdiction. The program also barred U.S. persons from doing business with any designated individual or group.<sup>117</sup> Shortly after the United States acted, the United Nations Security Council adopted a resolution (UNSCR 1373) imposing an obligation on all states to criminalize the provision of financial support to terrorist groups. The Security Council also obligated states to deny safe haven to terrorists, bring them to justice, prevent the movement of terrorists, and prevent the financing of terrorism.

In doing so, the United States, the United Nations, and the rest of the international community were speaking the language of prevention. Put more broadly, “the United States is trying to eradicate terrorist organizations,” including by curtailing their funding, “and those organizations know it.”<sup>118</sup> The language used by senior U.S. government officials when they impose sanctions on persons for providing support to terrorist groups confirms this strategy. They speak about the need to “unravel and disrupt” funding schemes that support al Qaeda and the Nusrah Front;<sup>119</sup> the need to “deplet[e] the financial strength of violent terrorist organizations”;<sup>120</sup> to “maintain maximum pressure” on groups like Hezbollah;<sup>121</sup> and of the importance of “[d]enying ISIL [Islamic State of Iraq and the Levant] access to the international financial system.”<sup>122</sup> With respect to the groups themselves, then, the goal is clear. As President Obama has vowed, “We will destroy ISIL and any other organization that tries to harm us.”<sup>123</sup> The pursuit is absolute, not conditional, as it is with regime-based sanctions. And the same purpose applies with respect to narco-trafficking and transnational organized crime groups.<sup>124</sup> The objective in these contexts is to “disrupt [their] ... illicit activities”<sup>125</sup> and “cut off ... access to the international financial system.”<sup>126</sup>

***At their most basic level, sanctions imposed on terrorist groups are designed to deprive them of their access to funds and to the architecture of the international financial system.***

A corollary objective is to protect the integrity of the international financial system from abuse.<sup>127</sup> The international financial system fundamentally relies on trust. If terrorist financing and other forms of financial crimes are able to take place unchecked, confidence in financial markets can erode.<sup>128</sup> Imposing sanctions on parties that use the financial system to engage in unlawful activity is an effective way to impose accountability on criminals and to work toward the transparency necessary to continue the process of identifying and disrupting illicit financial networks.<sup>129</sup> Markets that are a haven for illicit activity can fail to attract trade and investment needed in a global economy. And conduct-based sanctions contribute to the goal of stable, effective financial markets by constraining the ability of nefarious actors to participate in them in the first instance.



**COERCION – SHIFTING THE BEHAVIOR OF SUPPORTERS AND WOULD-BE SUPPORTERS**

Terrorist groups exist within a larger ecosystem of financiers, facilitators, and others that provide them with the personnel, money, and materiel they need to function. Sanctions against terrorist groups therefore also aim to compel those already involved in illicit activity to cease and deter those sitting on the sidelines from becoming involved at all. It is perhaps with respect to these members of the counterterrorism ecosystem that financial sanctions are the most successful but least amenable to measurement – for it is impossible to tally those who consider becoming involved in illicit activity but refrain from actually doing so.

The importance of disaggregating terrorist financing networks into their component parts was one of the earliest insights of post-9/11 work on adapting Cold War era deterrence research to the challenge of terrorism. Thus, the 2002 *U.S. National Security Strategy* proclaimed, “Traditional concepts of deterrence will not work against a terrorist enemy whose avowed tactics are wanton destruction and the targeting of innocents; whose so-called soldiers seek martyrdom in death and whose most potent protection is statelessness.”<sup>130</sup> But even at that early juncture, researchers already were hard at work developing frameworks that divided terrorist networks into those components that could not be deterred and those that were subject to influence. In this vein, Paul Davis and Brian Michael Jenkins suggested that terrorist systems must be examined at the level of their constituent parts, “some elements of which are potentially more vulnerable than others” to coercive influence.<sup>131</sup> Davis and Jenkins note specifically in that regard that “the wealthy Arabs who continue to finance [al Qaeda’s] activities ... *do* have something to lose,” and therefore can be swayed to stop providing support.<sup>132</sup>

***Sanctions against terrorist groups aim to compel those already involved in illicit activity to cease and deter those sitting on the sidelines.***

In other contexts, including narco-trafficking, the United States has presented the potential for delisting as an incentive for behavior change. And indeed, the regulations that govern OFAC prescribe a process according to which people can seek their removal from any sanctions list they may be on. In 2013, for example, after the Treasury Department delisted a Colombian

soccer team that had demonstrated its lack of continuing connection with sanctioned drug cartels, the then Under Secretary of the Treasury for Terrorism and Financial Intelligence David Cohen explained that “we will lift sanctions in cases where there has been a concrete change in behavior.” A year later, when the United States delisted the remaining sanctioned parties linked to the Cali cartel in its single largest delisting before “Implementation Day” under the JCPOA, the Treasury stated its strategy unequivocally: “The primary goal for sanctions is behavioral change,” and the removal was a result of “the people and entities delisted today credibly show[ing] that they have stopped engaging in sanctionable activities.”<sup>133</sup>

**MESSAGING – SHIFTING THE PUBLIC NARRATIVE**

A final goal of financial sanctions involves shaping the public narrative about a particular threat or individual in order to catalyze action by a domestic or international constituency. This “signaling aspect of sanctions is under-appreciated in the scholarly and policy literature on sanctions,” but is incredibly important to understanding the ways in which the tools of economic statecraft are actually used.<sup>134</sup> Financial sanctions can serve this role because designations are accompanied by press releases or statements that describe the reasons why sanctions are being imposed in a particular case. These narratives establish the factual predicate for a designation and inform the public debate and dialogue about the matter at hand. There are two subtly different motivations embedded within this rationale for imposing sanctions alone or in combination with others. The first involves increasing general public knowledge about the means, methods, and actors involved in facilitating the provision of support to illicit non-state actors. This helps banks, money transmitters, and other intermediaries recognize and stop the flow of illicit financial activity. The second is to engage in the war of ideas against these groups by introducing counter-narratives about their operations, operators, and support structures designed to undermine how these entities portray themselves and seek support within a larger context.

A clear example of the use of a sanctions designation to shape a public narrative about a particular terrorism problem is the case of Anwar al-Aulaqi, an American-born leader of al Qaeda in the Arabian Peninsula (AQAP) who was killed in a drone strike in Yemen in September

2011.<sup>135</sup> Aulqi posed a substantial challenge to the global counterterrorism community. He was an American citizen, fluent in English, whose preaching appeared to have a unique ability to inspire Westerners to commit themselves to al Qaeda.

But Aulqi was much more than a firebrand preacher. On Christmas Day 2009 Omar Farouk Abdulmutallab attempted to detonate a bomb hidden in his underwear on Northwest Airlines flight 253. The bomb did not work as AQAP had hoped and so disaster was averted. But during the course of his interrogation, it became clear that Aulqi had a substantial role in Abdulmutallab's recruitment and in the operational planning that preceded the attack. Indeed, "the detailed account given by Abdulmutallab when he started talking to his FBI interrogators in late January 2010 ... convinced intelligence analysts that al-Awlaki [sic] had evolved from a mere propagandist into a person who played a specific, operational role in plotting terrorist attacks."<sup>136</sup>

The press release that accompanied Aulqi's designation in July 2010 was the first time that the U.S. government described his operational role at length, and the United States used the occasion of the imposition of sanctions to shape the public narrative about Aulqi's operational significance to AQAP. In the press release, the government noted that:

*Aulqi has pledged an oath of loyalty to AQAP emir, Nasir al-Wahishi, and plays a major role in setting the strategic direction for AQAP. Aulqi has also recruited individuals to join AQAP, facilitated training at camps in Yemen in support of acts of terrorism, and helped focus AQAP's attention on planning attacks on U.S. interests.*

*Since late 2009, Aulqi has taken on an increasingly operational role in the group, including preparing Umar Farouk Abdulmutallab, who attempted to detonate an explosive device aboard a Northwest Airlines flight from Amsterdam to Detroit on Christmas Day 2009, for his operation. In November 2009, while in Yemen, Abdulmutallab swore allegiance to the emir of AQAP and shortly thereafter received instructions from Aulqi to detonate an explosive device aboard a U.S. airplane over U.S. airspace.<sup>137</sup>*

Similarly, in 2011 the U.S. government designated Yasin al-Suri, a prominent Iran-based al Qaeda facilitator who moved money and recruits from across the Middle

East, through Iran and into Pakistan, for the benefit of al Qaeda's senior leaders.<sup>138</sup> In the press release announcing the designation, the government revealed the existence of an agreement between al Qaeda and the Iranian government by which the terrorist group was permitted to "funnel funds and operatives through [Iran's] territory."<sup>139</sup> The link between the Iranian government and al Qaeda added a new dimension to the understanding of how both groups operate.

Finally, in designating four leaders of Hezbollah's external operations wing in 2013, the U.S. Department of the Treasury described some of the myriad ways in which the group supports terrorism throughout the world and is not simply a Lebanese "resistance" group.<sup>140</sup> These activities range from "assisting fighters from Iraq to support the Assad regime in Syria, to making payments to various factions within Yemen, and to military leaders responsible for terrorist operations in Egypt, Jordan, Turkey, Cyprus, Israel, the Palestinian territories, and Iraq."<sup>141</sup> The press release in that case was used to dispel a dimension of the group's self-constructed mythology and emphasize its role as a transnational terrorist organization involved in activities that destabilized a range of countries throughout the Middle East.



*By designating Hezbollah leaders in the last several years, the U.S. Department of the Treasury has shaped the public narrative regarding the group. The Treasury has described how the group is more than a Lebanese "resistance" group and in fact supports global terrorism. Here, the Hezbollah flag and logo fly in Baalbek, Lebanon. (Wikimedia Commons/yeowatzup)*

## Effects on Targets

Notwithstanding their centrality to the global campaign against illicit actors like terrorist groups and narco-traffickers, it has been difficult to measure and quantify the effects of sanctions targeting non-state actors in the same way this paper did for sanctions targeting states.

Nevertheless, government officials from the United States, United Nations, and elsewhere speak regularly about the importance and impact of curtailing the sources of financial support to terrorist groups in the overall struggle against terrorism. In this regard, David Cohen noted, “Through the application of powerful national and international sanctions, close cooperation with foreign partners and the private sector, and enhancements to international financial transparency, we have made it harder than ever for terrorist groups to raise, move, store, and use funds.”<sup>142</sup> And Daniel Glaser, also a senior Treasury Department official, similarly explained in 2011 that “[t]hrough the use of targeted financial measures, the development of innovative mechanisms for collecting financial intelligence and sustained engagement with key jurisdictions, we have systematically undermined terrorist financial networks across the globe, with notable success against core Al-Qa’ida [sic], our greatest threat.”<sup>143</sup>

In the post-9/11 period, scholars have noted the success of the international community in “significantly hobbling terrorist groups by restricting access to legitimate financial channels.”<sup>144</sup> Disrupting the sources of financial support to ISIS has been a core component of the global coalition’s approach to degrading and destroying the group.<sup>145</sup> Recent U.N. Security Council Resolutions designed to address the threat posed by ISIS emphasized “that sanctions are an important tool under the Charter of the United Nations in the maintenance and restoration of international peace and security, including in support of countering terrorism.”<sup>146</sup> Indeed, in the context of the counter-ISIS financing campaign, the U.N. Security Council hosted its first meeting chaired by national finance ministers in December 2015.

While it might be difficult to determine the impact of sanctions in the aggregate, it might still be possible to do so in the case of an individual group or at a specific interval of time. In the context of the battle against ISIS’s sources of support, for example, a senior U.S. official has noted a decline in oil production and diminished transportation capacity after a concerted U.S. effort to strike at valuable assets, ranging from

the destruction of costly oil production infrastructure to tanker trucks, where 400 have been destroyed, increasing transportation costs.<sup>147</sup>

With improved record-keeping and transparency at money exchange houses and other informal value transfer systems in certain parts of the world, it also might be possible to estimate the amount of financial activity that has moved from the formal to the informal financial system in response to sanctions measures.

***Some data supports the assertion that sanctions undermine the ability of terrorist groups to raise, store, move, and use funds.***

Thus, we have evidence based on public statements from government officials that financial sanctions are having significant effects on non-state actors,<sup>148</sup> and some data to support the assertion that sanctions undermine the ability of terrorist groups to raise, store, move, and use funds. Nevertheless, “[m]aking sanctions smarter, and measuring their impact, are constant challenges.”<sup>149</sup>

Shadowy terrorist groups and narco-trafficking networks will never generate the kind of data that would demonstrate the impact that financial sanctions have on their operations. And without such data, determining the effectiveness of such measures will be difficult. But by keeping in mind the purposes of sanctions imposed against non-state actors, and with some greater transparency in ways recommended below, the use of the tool can be refined further and with greater effect.

## **04 CHAPTER**

# **The Challenges of Contemporary Sanctions to the United States and on the Global Financial System**

In contrast to the previous chapters, which focused on the effects and effectiveness of sanctions imposed on the targets of those sanctions, this chapter will highlight some of the effects that modern financial sanctions have had on the United States, its allies, and the international financial system as a whole. Some of the dynamics described below are still beginning to take shape, and it is impossible to determine at this juncture whether they ultimately will have strategic significance. One key reason for this is the difficulty in gathering extensive data to systemically determine the scope and severity of these challenges. But because of the potential for these challenges to merit significant strategic concern, and in considering the long-range impact of financial sanctions, the sets of issues outlined below demand attention.

*As economic sanctions have become more targeted, innovative, and focused on the provision of financial services, some negative effects have emerged.*

As described above, the United States has innovated substantially in using financial sanctions in the post-9/11 era, with important successes in changing behavior, as in the Iran and Burma cases, and in choking off the ability of terrorist groups to raise, store, move, and use funds. As economic sanctions have become more targeted, innovative, and focused on the provision of financial services as the key intermediary for exerting pressure on sanctions targets, however, some negative effects have emerged for the United States and for the international financial system. Over time these externalities may undermine the availability and integrity of sanctions as a tool of American statecraft, and in so doing, also may undermine the ability of the United States to use sanctions as a way to exert pressure and shape the incentives of adversaries that can complement diplomacy without the recourse to military force in the future.

The first of three broad categories of impacts derived from the use of sanctions is related to the global financial sector. This includes the “de-risking” phenomenon, which is a process by which private companies prophylactically abandon activities they perceive to pose financial crimes compliance risk, for fear that they will be subject to substantial fines if they inadvertently engage in proscribed activities. De-risking can have an impact on other policy priorities, such as financial inclusion,<sup>150</sup> and on the sustainability of the enterprise of financial sanctions. It can reduce the reach of the formal financial sector, driving illicit activity to unregulated spaces, and may impugn the legitimacy of sanctions as a tool of statecraft. This category of risk also includes the possibility that the U.S. dollar’s global dominance – the jurisdictional source of America’s power in economic statecraft – will be reduced. The second category of challenge pertains to the U.S. government’s internal organization for the imposition of financial sanctions. As sanctions become more innovative, complex, and more closely integrated into the heart of U.S. national security strategy, the U.S. government will need to become better organized to create and implement sanctions policies. And finally, there have been challenges to the strategy of sanctions – namely the ways in which sanctions have been integrated into larger strategic approaches to particular foreign policy problems.

### **Impact on the Global Financial Sector**

In the face of extensive sanctions regimes and significant enforcement actions for sanctions violations, some elements of the private sector have begun to react preventively to mitigate their exposure to financial crimes risk. The regulatory fines and reputational harm that financial institutions can suffer as a result of violating sanctions, and ambiguities about the outer limits of sanctions enforcement strategy, have deterred the banking and finance sector in particular from opportunities abroad that they perceive as too risky. Additionally, some international companies and

governments are developing non-U.S. financial platforms or looking increasingly to non-U.S. currencies to avoid exposure to U.S. jurisdiction for the purpose of sanctions enforcement and compliance.

## DE-RISKING

De-risking has negative effects on policy priorities of the United States and thus demands sustained attention. It impedes the ability of the U.S. government to use sanctions as incentives – critical to the ability to compel changes in behavior, as discussed in chapter two – in two ways. First, it could limit the potency of sanctions measures in the future; if no financial relationships exist with a particular jurisdiction, prohibiting transactions and financing through sanctions will not generate leverage for behavior change. Second, de-risking could inhibit the government’s ability to unwind sanctions and create positive incentives for changes in behavior when it desires to do so because financial institutions will decline to re-engage in formerly sanctioned states.

In practice, de-risking occurs in several different ways: when banks choose to terminate accounts that might attract regulatory attention rather than potentially expose themselves to fines if they keep them open;<sup>151</sup> when, more broadly, banks pull out of and/or sever correspondent relationships with places like the Middle East exposed to potentially sanctionable or sanctioned bodies; or through “pre-risking” – not opening up any accounts at all with respect to certain categories of activity.<sup>152</sup> These actions make commercial sense to banks because civil penalties for sanctions violations are imposed on a strict liability basis, meaning companies can face liability even if they did not willfully violate sanctions regimes. In practice, a survey of 17 banks found that thousands of correspondent banking relationships have been terminated since 2011.<sup>153</sup> After HSBC was fined in 2012, for example, it reportedly began to terminate relationships in countries it deemed too risky.<sup>154</sup>

In November 2015, the World Bank published an initial report finding that half of the 110 banking authorities it surveyed worldwide<sup>155</sup> reported a decline in correspondent banking. The figure jumped to 75 percent of international banks; American banks were the most likely to have terminated correspondent banking relationships.<sup>156</sup> In early 2015, California Merchants Bank, which previously processed 60–80 percent of Somali

remittances from the United States, refused to transfer any more money to Somalia, which more broadly has experienced trouble receiving funds from the Somali diaspora in the West – a critical challenge for a country that relies heavily on remittances.<sup>157</sup> And domestically, in May 2015, major U.S. bank branches terminated their business in the border city of Nogales, Ariz., because their compliance departments believed it carried too much risk for money laundering.<sup>158</sup>

The World Bank, the Financial Action Task Force (FATF), and Federal Reserve have expressed particular concern for how de-risking might affect financial inclusion by making it difficult or impossible for migrants to make remittance transfers.<sup>159</sup> In one recent case, when de-risking imperiled significant remittances, a Somali money transmitter successfully fought a bank’s termination of banking relationships. In 2014, Barclays was the last major bank facilitating remittances to Somalia.<sup>160</sup> The bank attempted to cut off its relationship with Dahabshiil, a Somali remittance provider. Barclays had sought to eliminate Dahabshiil’s extensive business with Somalia as it sought to reduce risk in its relationships. But Dahabshiil obtained an injunction against Barclays and later a settlement to accommodate its business.<sup>161</sup> The Dahabshiil case may represent a rare public victory for financial institutions trying to stave off the de-risking phenomenon.

### ***De-risking impedes the ability of the U.S. government to use sanctions as incentives – critical to the ability to compel changes in behavior.***

De-risking also has implications for foreign policy and strategic interests of the United States and its allies. For countries like Jordan, Lebanon, and Turkey, which are close American allies but also financial markets that sanctioned parties are likely to use (and abuse) due to their proximity to terrorist groups like ISIS and Hezbollah, de-risking might have significant consequences for the stability and viability of their banking sectors (and, by extension, for their economic well-being more generally).<sup>162</sup>

The phenomenon also generated diplomatic challenges for the United States in 2010 and 2011, when banks in the United States closed accounts for diplomatic missions of countries like Angola for fear of inordinate

financial crimes compliance risk and/or cost.<sup>163</sup> In January 2011, diplomats from China, South Africa, and Turkey, among other nations, informed the Treasury and State Departments that the bank terminations had affected their diplomatic missions to the United States as well.<sup>164</sup> By 2012, the State Department began pressing banks to reopen these accounts because of the strain the withdrawal of banking services had on diplomatic relationships. The banks in effect asked for assurances that resuming embassy business would not lead to enforcement actions, but the State Department had no authority to grant them their request.<sup>165</sup> The situation was not resolved fully; in January 2015, the State Department gave a presentation on banking and compliance in which it emphasized it did not have the power to compel a banking relationship but allowed two banking representatives to discuss best banking practices with foreign diplomats.<sup>166</sup>

De-risking also might affect the United States' financial pre-eminence. Thomas C. Baxter, executive vice president and general counsel of the Federal Reserve, argued in February 2015 that de-risking might have problematic implications for the United States "with respect to the role of the dollar as the international medium of exchange."<sup>167</sup> And the financial exclusion of large numbers of people also pushes higher risk clients to banks that might have fewer resources to detect illegal activity.<sup>168</sup> Baxter has observed the trend of "adverse and unintended consequences" for the affected regions of the world and implored business leaders to rethink their compliance programs with the potentially affected populations in mind.<sup>169</sup>

***Although China has been fighting for economic parity with the United States in general, Russia also is taking steps to immunize its economy from sanctions.***

When analyzed closely, the de-risking phenomenon presents something of a paradox. While clearly there are changes occurring in the international banking system in response to these dynamics, it has proved challenging to identify the causal mechanisms with precision. Some commentators, for example, have noted that de-risking is in part a product of the significant fines to which banks have been subject in recent years.<sup>170</sup> In 2014 BNP Paribas was fined \$8.9 billion; in 2012 HSBC reached an

agreement with the U.S. government and paid nearly a \$2 billion penalty; and also in 2012, Standard Chartered paid nearly \$1 billion in fines to settle allegations of sanctions violations. These fines and settlements have significantly shaped the risk tolerance of global financial institutions – after all, they reason, almost no transactions or relationships generate enough profits to be worth the potentially significant fines and reputational damage that can result from these enforcement cases.

***While there are changes occurring in the international banking system in response to these dynamics, it has proved challenging to identify the causal mechanisms with precision.***

But when examined more closely, this explanation might not prove as persuasive as it seems at first glance. The magnitude of the fines levied against BNP Paribas, HSBC, Standard Chartered, and others were all criminal in nature, having emerged from willful violations of law, which often included measures to evade sanctions restrictions. They were not the kinds of inadvertent violations of sanctions restrictions that banks claim are driving the de-risking phenomenon. Further, the lack of full coordination and alignment between various financial regulators in the United States, which they believe and fear will increase the cost of the charges brought against them, creates yet more reason to avoid any transaction or relationship of concern.

Another paradox of the de-risking phenomenon is that it also may be attributed to concern about avoiding general financial crime, rather than sanctions violations. In Mexico and Central America, for example, where many financial institutions are canceling correspondent banking relationships, the concerns about avoiding money laundering and the financial flows of criminal activity, including drug, weapons, and human trafficking, are a key driver.<sup>171</sup> Additionally, in a period of cost-cutting and global retrenchment by banks, commercial decisions to lower exposure to potential financial risks of all kinds are understandable.

Finally, the de-risking phenomenon has been difficult to confront because it is difficult to gather sufficient data to measure with confidence how many global correspondent banking relationships have been canceled, or accounts closed or refused, due to concern

over sanctions as opposed to other activities. Even more difficult is the exercise of determining which canceled relationships or accounts can be attributed to true concern over sanctions or financial crime liability, versus a more prudential concern about inadequate profit margins from a certain line of business or customer constituency. The implication of this is that it may be difficult to ascertain exactly how much de-risking is truly de-risking as defined in this section, and how much canceled business is hiding behind this guise or mislabeled. Some so-called de-risking may actually be beneficial if financial institutions are making more careful decisions about managing, though not avoiding, risky counterparties. In any case, while research and industry analysis into this phenomenon is more anecdotal and qualitative than rigorously quantitative at this point, the severity of concern about the de-risking phenomenon has drawn the attention of global financial leaders and well-respected multilateral financial institutions.

Because de-risking poses a challenge for the international financial system, policymakers from a range of jurisdictions have made efforts to understand and address it, while regulators have encouraged banks to re-examine customer relationships rather than break them off.<sup>172</sup> As the then-Under Secretary of the Treasury for Terrorism and Financial Intelligence David Cohen explained in 2014, “[D]e-risking’ can undermine financial inclusion, financial transparency and financial activity, with associated political, regulatory, economic and social consequences.”<sup>173</sup> As banks exit a particular market, they reduce competitiveness, which increases costs and decreases banks’ motivation to enact best business practices. De-risking also undermines the trend toward adoption of a “risk-based approach” to the management of financial crimes compliance. A risk-based approach, which the FATF identifies as a best practice for financial crimes compliance activity,<sup>174</sup> requires banks to only terminate accounts or relationships where banks cannot manage the risks for terrorist financing, money laundering, or other illicit activity.<sup>175</sup> Ideally, businesses would make financial decisions based on the actual risk of the underlying activity, on a case-by-case basis, rather than as a result of the risk of potential regulatory enforcement. As Cohen stated, “[D]e-risking’ is the antithesis of an appropriate risk-based approach.”<sup>176</sup>

But despite the difficulties in identifying with precision the outer boundaries of the phenomenon and its underlying dynamics, de-risking is likely to remain a part of the financial crimes compliance landscape for the foreseeable future.



**ARCHITECTURAL CHANGES – SHIFTS IN THE STRUCTURE OF THE INTERNATIONAL FINANCIAL SYSTEM**

The second major impact of sanctions on the countries imposing them, as well as on the broader international financial system, involves a series of inchoate changes to the underlying architecture of the international financial system.

The ability to deploy and enforce financial sanctions fundamentally depends on the widespread use of the U.S. dollar for a significant proportion of global financial activity. Because the U.S. financial system is the largest and most liquid in the world, as well as fairly transparent, stable, and reliable, U.S. currency is used for a wide range of transactions that have little otherwise to do with the U.S. economy. These include, for example, the majority of the global trade in oil and almost all commodities. And because almost all U.S. dollar transactions of any significance must cross the U.S. financial system, they become subject to U.S. jurisdiction for the purpose of sanctions enforcement.

People and businesses all around the world therefore use U.S. dollars and U.S. dollar-denominated financial instruments for a wide range of purposes, fundamentally because of its perceived stability and because of the large liquid market for U.S. dollar securities. While the United States only produces 23 percent of global economic output, the dollar is responsible for 43 percent of cross-border transactions and 63 percent of known central bank reserves.<sup>177</sup> Trade finance is even more significantly dollar-denominated compared to global trade, with 80 percent of Letters of Credit, and a high proportion of the activities of global and local banks, denominated in dollars.<sup>178</sup>

***The ability to deploy and enforce financial sanctions fundamentally depends on the widespread use of the U.S. dollar for a significant proportion of global financial activity.***

Of late, however, changes have started emerging in the international financial system that may over time make fewer transactions subject to U.S. jurisdiction, and thus to the reach and power of U.S. economic sanctions. In October 2015, for example, China introduced its Cross-Border Inter-Bank Payments System (CIPS).<sup>179</sup> This mechanism of bank payment messaging is similar in

function to SWIFT, and is meant to establish an independent yuan-denominated payment clearing system. The establishment of CIPS was driven by a range of factors, many of which have to do with China's economic and commercial aspirations in East Asia, but also derives at least in part from concerns that SWIFT has an overly close relationship with Western security services and interests.<sup>180</sup> Creating an international clearing system that uses the yuan also makes the yuan more competitive with the dollar as a cross-border currency.<sup>181</sup>



*Prime Minister Dmitry Medvedev addresses the crowd at the Sochi-2014 International Investment Forum. This plenary session, "Russia between Europe and Asia: A New Regional Policy in Modern Circumstance," suggests Russia's shifting view toward the East following a weakened relationship with the West over sanctions. (Government of the Russian Federation)*

Transactions cleared through CIPS are not denominated in U.S. dollars, do not touch the U.S. financial system, and therefore may not be subject to U.S. jurisdiction for the purpose of sanctions enforcement (or, for that matter, for any other purpose). In theory, therefore, businesses outside the United States and in which U.S. persons are not involved could conduct transactions using CIPS that would be prohibited by U.S. sanctions laws if they were denominated in U.S. dollars.

Although China has been fighting for economic parity with the United States in general, Russia also is taking steps to immunize its economy from sanctions by creating an alternative to SWIFT.<sup>182</sup> Russia has been seeking to free itself from the confines of using SWIFT for some time; it has already created a domestic alternative to SWIFT, and is in the process of developing an international alternative with BRIC countries.<sup>183</sup> It also

has made other moves to more independent financial processing systems: MasterCard and Visa, for example, signed agreements to continue transactions in Russia despite sanctions levied by the United States as a result of Crimea.<sup>184</sup>

To be sure, CIPS faces limitations – in the liquidity of the yuan, confidence in the Chinese government’s fiscal and monetary policy, Beijing’s uncertain commitment to property rights and rule of law, and the system’s operational hours and geographic scope. For now, it is most useful for transactions into and out of China.<sup>185</sup> But the fear is that China and others are slowly replacing the fundamental architecture of the international financial system in a way that will make it more difficult for the United States to use the tools of economic statecraft to protect its interests and those of the international community in the future. Moreover, the United States and its allies fear that the extent of their powerlessness will be revealed after it is too late to do anything about it, and that it will have non-linear effects on the Western financial system. Even before this may occur, however, the phenomenon of global commerce shifting away from the dollar is concerning to those watching for sanctions evasion. The more adept that Russian and Iranian companies become at structured finance, commodity transactions, and trade transactions outside of the dollar, the more difficult it will be to toughen or snap-back sanctions if merited by policy priorities.

For now, at least, there are structural reasons relating to the operation of the international financial and commercial markets that will limit the extent to which the yuan or other currencies will be able to supplant the U.S. dollar’s dominance. First, and most important, the size and liquidity of the market for the U.S. dollar is unmatched by that of any other currency. For this reason, companies around the world use short- and long-term U.S. dollar denominated securities for cash management purposes in a way that no other currency will be able to supplant easily, at least not in the near term.

The size and liquidity of the U.S. dollar markets are likely to remain dominant as long as global commodities, particularly oil, are traded in U.S. dollars. Given the fact that the United States itself is currently one of the world’s largest oil producers, and that several of the next largest – Saudi Arabia, Iraq, the United Arab Emirates, and Canada – are under the security umbrella of the United States (and in the case of Saudi Arabia and the United Arab Emirates, they peg their currency

to the U.S. dollar), none of those states are likely to support a re-denomination of oil. Given their continued reliance on the United States for their security, and their substantial holdings of U.S. dollar foreign currency reserves, pushing to re-denominate oil would introduce significant political and economic risk to these countries at a time when the Middle East security situation is already precarious. Many of the world’s largest and most significant economies hold a significant portion of their foreign currency reserves in U.S. dollars, and almost all currency pegs in the world are to the U.S. dollar, making it considerably more difficult to shift away from the greenback in global commodity trading.

***Sanctions policy has become subject to the partisan disputes that have characterized a great many foreign policy challenges in the last several years.***

Not only is the U.S. dollar’s position firmly entrenched in the international system, but there are also important obstacles to the emergence of the yuan as a threat to the dollar’s dominance, not the least of which are concerns about the ability of the Chinese government to manage complex economic challenges.<sup>186</sup> Whether or not the position of the dollar is ever decisively threatened, it is important to keep in mind the relationship between the use of financial sanctions and the global strength and position of the U.S. dollar.<sup>187</sup>

## **Internal U.S. Government Structure for Sanctions Programs**

As sanctions have grown more complicated and more central to U.S. security strategy, the imperative to coordinate among agencies involved in sanctions policy and enforcement has grown more acute. Paradoxically, however, there has been substantial growth in the nature and number of entities at the federal, state, and local level with involvement in sanctions enforcement, resulting in a fragmentation of authority and a mismatch between policymaking responsibility with respect to sanctions and enforcement authority. The White House, for example, does not have a senior advisor in charge of sanctions policy as it increasingly overlaps with other important foreign policy tools – a person who might be able to advise when sanctions should be used and how

they should be combined with diplomatic, military, and intelligence initiatives to address particular problems. Instead, questions about sanctions are handled on a case-by-case basis.

Congress, too, has a role in the design of sanctions programs, and sanctions policy has become subject to the partisan disputes that have characterized a great many foreign policy challenges in the last several years. This dynamic has emerged recently in a number of cases. While President Obama was able to lift certain trade and travel restrictions on Cuba in 2015 relying on executive authorities, congressional action is required to fully restore economic relations.<sup>188</sup> Shortly after the president announced his initiative, leading congressional politicians from both parties took to the media to announce their resistance to Obama's plan,<sup>189</sup> and the legislation that would be required to fully lift the embargo against the island nation has not been enacted. A few months later, when the Obama administration introduced the JCPOA with Iran, congressional leaders announced their intention to extend a sanctions law that Iranian officials stated they would consider a violation of the nuclear agreement.<sup>190</sup>

Beyond partisan rhetorical challenges to the executive branch's authority, congressional leaders are increasingly inclined to intervene in the design and execution of sanctions programs at a tactical level, adding another complexity to the web of actors.<sup>191</sup> Congress has, for example, attempted to write the names of putative sanctions targets into statutes (and done so in at least one case: Islamic Republic of Iran Broadcasting<sup>192</sup>), adopted new definitions for ownership or control of sanctioned bodies, attempted to identify what constitutes the provision of material support to proscribed entities, and sought to prevent executive action from providing sanctions relief.<sup>193</sup> In the relatively recent past, several congressional measures on Iran further attempted to strengthen congressional oversight into economic sanctions. Congressman Steve Russell (R-Texas) sponsored the Iran Terror Financing Transparency Act, and Senator Benjamin Cardin's (D-Md.) draft bill on Iran sanctions further attempted to prevent the president from removing specially-designated nationals (SDNs) from sanctions lists without submitting a certification to Congress.<sup>194</sup>

This fragmentation of authority and competency exists between the federal government and its state and local counterparts as well. These policymaking

bodies, enforcement agencies, and regulatory groups shape sanctions enforcement, but do not generally have jurisdiction over sanctions policy. They have different agendas and authorities with which they approach sanctions-related issues, which can lead to a divergence between the goals that sanctions policy seeks to achieve and the enforcement actions that give teeth to regulatory measures. Most notably, new bodies, like New York's Department of Financial Services (DFS), have begun to undertake sanctions enforcement without coordinating with federal bodies.<sup>195</sup> In 2012, for example, the DFS levied fines on Standard Chartered Bank without notifying federal bodies of its actions, despite the fact that federal regulators were also pursuing cases for the same sanctions violations in collaboration with DFS.<sup>196</sup>

## Sanctions Strategy

Finally, the ways in which sanctions have been used by the United States and its allies in the post-9/11 era have generated changes in the international environment that the United States will have to address in the coming years. These changes fall principally into three categories. The first are challenges in unwinding sanctions, which will make it more difficult to reward target countries for complying with the wishes of the international community, thereby potentially undermining the effectiveness of sanctions as a foreign policy tool. The second has to do with relationships with U.S. allies on sanctions issues, and potential divergences between the United States and Europe on sanctions policy. And the



*President Obama delivers a speech at the University of Yangon in Myanmar on November 19, 2012. Despite easing sanctions on Myanmar, the lack of investors returning to the country evidenced the costs and unforeseen consequences of unwinding sanctions. (White House/Pete Souza)*

third has to do with the proliferating use of the tools of financial sanctions by other countries and the need to prepare for potential retaliation.

#### **CHALLENGES IN THE STRATEGY OF SANCTIONS – UNWINDING**

Difficulties in unwinding sanctions may lead to challenges in achieving the compellant benefits that sanctions against states are meant to achieve. Over the long term, if sanctions cannot be unwound in response to changes in behavior by the target state, future target states may lose their incentives for compliance, and sanctions will begin to look punitive (rather than coercive) in nature.

The key test for this dynamic will be Iran. Initial reactions to the JCPOA by the United States and its Western European allies embodied significantly different approaches to business with Iran. The United Kingdom expressed its desire to begin strong economic relationships,<sup>197</sup> France was actively courting Iranian businesses,<sup>198</sup> and Germany sent the first top Western official after the deal was concluded.<sup>199</sup> There are reports of American investors going individually, and at times surreptitiously,<sup>200</sup> as the vast majority of sanctions on U.S. persons that prevent them from doing business in Iran remain in place.

***If Iran does not see financial benefits from the JCPOA, it will no longer see an incentive to comply with the agreement's restrictions on its nuclear capabilities.***

This will complicate substantially the compliance landscape for large multi-national corporations seeking to re-engage with Iran, but also to avoid involvement with terrorist financing, money laundering, corruption, U.S. sanctions that remain in place, and other financial crimes compliance (and substantial reputational) risks in Iran.<sup>201</sup> Ultimately, some observers suspect that the cost of doing business in Iran will be too high for Western companies concerned to avoid risk, particularly if oil prices remain low for a sustained period of time. If Iran does not see financial benefits from the JCPOA, they fear, it will no longer see an incentive to comply with the agreement's restrictions on its nuclear capabilities.

Other countries where sanctions were lifted give some idea of what Iran can expect as nations tentatively begin

investigating economic opportunities. The aftermath of unwinding sanctions on Burma, for example, confirms that unwinding longstanding sanctions in situations of political uncertainty – in both the sanctioning countries and the sanctioned – is a challenge. After the United States lifted most sanctions on Burma, there were strong initial signs of interest by the private sector in re-engaging there, followed by disappointment a few years later when the hoped-for participation in the Burmese economy by Western investors failed to materialize.

Those who tested the waters accused the United States of simultaneously encouraging investment while making it difficult to do so by keeping a few important, well-connected businesses related to Burma's former junta sanctioned.<sup>202</sup> One American investor noted: "It is almost like [Washington is] telling us to invest with a wink and a nod"; as another bluntly put it, "U.S. companies are severely handicapped by our government's unclear policy."<sup>203</sup> The difficulties companies faced in navigating a complex financial crimes compliance environment and a country in which many significant economic players remained subject to sanctions (including, most prominently, the major banks and the operators of all major sea and airports) dampened substantially the willingness of private companies to engage with Burma after the opening in 2012.

At the same time that target states seek rewards for changes in behavior, so too must understand that there will be clear consequences for cheating on the deals that they signed in response to lifting financial sanctions. Only in this way can the international community do as much as possible to reinforce the target's desire to stand by a deal.

#### **THE UNITED STATES AND EUROPE – DIVERGENCES ON SANCTIONS POLICY**

The globalization of the economy and the proliferation of American sanctions regimes as a part of the administration's foreign policy have implications for U.S. relationships with allies. Globally, allied countries must collaborate with the United States on broad foreign policy objectives, and sanctions in particular, in order for them to be effective. Recently, though, the United States has struggled at times to ensure multilateralism in its sanctions and allied support for its sanctions decisions. After the United States imposed sanctions on Russia in 2014, Senator Chris Murphy (D-Conn.) tied the EU's support for the sanctions into the transatlantic diplomatic relationship in general, explaining that the

sanctions were a crucial test of the unity of the EU and the United States in the face of an international crisis.<sup>204</sup>

Although the EU did eventually join the United States in sanctioning Russia (most significantly after the shoot-down of Malaysian Airlines Flight 17 in July 2014), tensions surrounding divergent approaches to Russia remain (and may continue up until the EU must renew its current sanctions in June 2016). Jean-Claude Juncker, the president of the European Commission, continued to make statements resisting the pressure to conform the EU's foreign policy and sanctions regime to the United States', explaining, "We can't let our relationship with Russia be dictated by Washington."<sup>205</sup> The United States' relationship to allies in the Western Hemisphere is also challenging with respect to sanctions. After the United States imposed sanctions on Venezuela in 2015, Latin American and Caribbean countries registered their discontent with the policy, signifying the most resistance to a sanctions regime since the United States embargoed Cuba.<sup>206</sup>

Because sanctions have become a signature element of American foreign policy, alignment on sanctions is a sign of diplomatic goodwill in general. When the government pursues sanctions that do not have multilateral support, or requests sanctions from its allies, it has the potential to upend diplomatic relationships.

### **THE POTENTIAL FOR RETALIATION**

Finally, retaliation against sanctions measures by nation-states or other actors is a major concern for the future longevity and viability of sanctions as a national security tool. Most prominent have been a series of cyber-attacks apparently conducted in response to the use of financial sanctions. In 2012, for example, the Department of Defense attributed cyber-attacks launched against U.S. banks to Iran,<sup>207</sup> conducted as retaliation for sanctions.<sup>208</sup> One set of cyber-attacks also hit commercial affiliates of American allies – Saudi Aramco, the national Saudi Arabian oil company, and Qatar's RasGas, a natural gas producer and exporter in Qatar.<sup>209</sup>

North Korea, too, has used cyber-attacks to target U.S. economic interests, in the attack against Sony Pictures in late 2014. The attacks cost the company a significant amount in material and reputational damage, as the company's networks were taken offline for some time, computers were destroyed, embarrassing emails and payroll information were released publicly, and litigation

ensued.<sup>210</sup> After North Korea attacked Sony (and U.S. commercial interests by proxy), the government retaliated with more sanctions.<sup>211</sup>

The threat of retaliation is a serious concern in the context of the new cybersecurity sanctions program.<sup>212</sup> If and when the United States deploys these sanctions, banks or others may find themselves subject of significant retaliation efforts. But the consequences of this threat remain unexamined, and modes of communication between government and the private sector about potential threats from this form of retaliation have not been established. Policy on retaliation remains underdeveloped; it is not known if American businesses or the businesses of American allies will be helped in any way in the event of retaliation for the use of cyber sanctions.

Retaliation also could have implications for the U.S. commitment to – and growing imperative for – multilateral sanctions. In late 2014, after the United States and EU imposed sanctions, Russia threatened to create a bill that would allow the Russian government to confiscate foreign assets.<sup>213</sup> While this clearly would be punishing for American business, the announcement also had immediate consequences on the global stock market and put Russia's energy relationship with the EU in question.<sup>214</sup> As U.S. collaboration with allied countries becomes more important for the continued effectiveness of sanctions, the U.S. and EU's alignment of interests also has become more difficult to maintain because of the threat of retaliation that both feel but to which the EU is asymmetrically vulnerable.

Many of the trends identified in this chapter are developing, but represent a significant new type of effect of the financial sanctions enterprise as practiced since 9/11. While it is unlikely that there will be decisive resolution of any one of these challenges, they must be considered in the course of developing sanctions programs on an ongoing basis. Ultimately, the effectiveness of financial sanctions must be considered holistically, taking into account the effects on the targets, the ability of those effects to generate desirable policy outcomes, and the negative externalities on the larger ecosystem within which sanctions operate.