THE BROOKINGS INSTITUTION
DOLLAR & SENSE
What is the role of sanctions in US foreign policy?
Monday, May 13, 2019

PARTICIPANTS:

DAVID DOLLAR
Senior Fellow, John L. Thornton China Center, Foreign Policy program, Global Economy and Development programs
Host

ELIZABETH ROSENBERG
Senior Fellow and Director, Energy, Economics and Security Program

(MUSIC)

DOLLAR: Hi, I'm David Dollar, host of The Brookings trade podcast "Dollars & Sense."

Today my guest is Elizabeth Rosenberg, senior fellow at the Center for a New American Security. Liz is the co-author of a new study on the use of financial and economic sanctions by the United States, so our topic today is going to be those sanctions, how do they work, [and] why the U.S. is uniquely placed to use these. We'll talk about some specific cases—notably Iran and North Korea—and what are some of the costs of using these. So welcome to the show, Liz.

ROSENBERG: Thanks, I'm glad to be with you.

DOLLAR: So I want to start by talking about what do we mean by these economic and financial sanctions, and I think it's easier to take a concrete case. You and I were both working in the U.S. Treasury Department as the Obama administration developed the Iran Nuclear Agreement and financial sanctions were a key part of that. So maybe you could explain in general how this works and use that as a concrete case.

ROSENBERG: Well, thanks. In some ways the Iran sanctions case is a good illustrative example of what the tool is and how the U.S. government uses it, and in others it's not very representational. So let me start by saying that the way that we think about sanctions now, they are financial instruments, they're actually banking sector restrictions primarily. That's a pretty contemporary understanding of how they work. It's about a decade old-ish, and before that what people thought of as sanctions had more to do with restrictions on trade. And there's a very diverse and much discussed history about the effectiveness of them. But let's set those aside and focus on the contemporary iteration of sanctions—these banking restrictions— because those are the kind of restrictions that were used in the Iran case and that are used most commonly now for a variety of different foreign policy aims.

So with regard to Iran, there were very powerful U.S. sanctions, and there were also sanctions imposed by other major economies in the E.U. and the U.N., but those U.S. ones were in the form of restrictions on a number of Iranian individuals and companies, government agencies, and those internationally who would do business with them, blocking them from access to the United States financial system and the dollar. Now that can be a death sentence for any major bank or company because of the centrality of the dollar to international commerce and as a store of value. So this was a very powerful set of banking restrictions the United States used to put Iran in a box and limit the ability of international companies and banks to do business with Iran. And up against a wall, with all of that pressure, Iran came forward and decided to engage in diplomatic negotiation which led us to the Iran nuclear deal, the JCPOA, in 2015.

DOLLAR: So I appreciate that distinction between these financial sanctions which are relatively new and the long history of trade sanctions, but this being the trade podcasts I do want to point out that the objective was to get a reduction in Iran's oil exports and reduce Iran's income. That was one of the objectives.

ROSENBERG: That was one primary…and another one was to cut off its access to the international financial system which of course has an important bearing on its ability to trade and transact anything else besides oil as well. And there were other sanctions on other economic sectors, but the ones that —at the time and retrospectively—we look back at and think were the most powerful, that really compelled Iran the most to engage in diplomacy, were those oil sanctions and the banking ones. And the oil ones of course because Iran, as a resource economy and significant producer and exporter of oil, relies so significantly, it is so vulnerable, to a cut off in its ability to export that oil.

DOLLAR: Now as you said some of our close partners had similar sanctions right from the beginning of this whole diplomatic effort, but there are other important countries like China which were not initially on board. China is the biggest importer of oil in the world. It imports quite a bit of oil from Iran—particularly in the past period we're talking about China was importing a lot. So did China go along and why would they?

ROSENBERG: That's a great question, particularly because these days in the realm of trade and policy the United States and China are so clearly differentiated in their views and objectives. But Iran is a good example of where the United States and China have quite shared and complementary goals about a concern for Iran's potential and destabilizing proliferation activities, and the United States and China as members of the Security Council have shared that concern and acted together with other Security Council members to impose a whole series of resolutions and sanctions that went along with them at the level of the U.N.

Now, China has leaned on that, in the Iran circumstance and others, saying we get on board with international law and U.N. Security Council resolutions and we don't appreciate the United States engaging in what they would call extraterritorial sanctions that would compel companies beyond the U.S. to abide by U.S. sanctions. So they, in a public facing articulation, have expressed over and over again frustration with U.S. sanctions, but when you look at the numbers it does appear that they complied with the sanctions and that toughest ramp up of pressure from 2012 about to 2015. And that means that they decreased on a rolling basis their imports of Iranian oil in line with what U.S. law demanded.

DOLLAR: Right. So during that period I was representing the U.S. Treasury in Beijing and so the way I saw that from my seat is the Chinese were not happy about the U.S. extra territoriality, but big Chinese companies and banks basically had to go along with this because if they didn't then they're cut off from the U.S. market—cut off from the whole dollar system. I think that's one of the points I want to get across to the listeners is that the dollar plays this unique role in the world and if you're cut off from dollar financing even if you don't do business in the United States that's really going to be the death penalty for a lot of companies.

ROSENBERG: Right, and it's not just dollar financing it's also the ability to use the dollar for effects transactions, as an efficient way to move one money from one currency to another even if you're just passing through the dollar on your way to the ruble or denar or what have you, as well as a store of value. And you really got the full force of it if you were in Beijing during this period. You heard a lot of frustrated Chinese officials, I can only imagine, reacting to that set of sanctions. From my perspective, when working with the U.S. government and subsequently, I have been impressed time and time again by the sophistication and expertise of Chinese banks and companies about U.S. sanctions. They know full well…the big ones know full well what it means to potentially violate U.S. sanctions or not, and that's one of the reasons why they have decided as you just saying not to violate U.S. sanctions.

DOLLAR: Yeah those are really excellent points. I think people often don't understand that most international trade takes place in dollars. You know, it may be a transaction between China and some other country, but it's usually conducted in dollars. And I think 90 percent of all foreign exchange transactions involve the dollar. So oftentimes if you're going from Chinese yuan to say British pounds, typically those transactions actually are two transactions: First you go from Chinese yuan to the U.S. dollar, then you go from the U.S. dollar to British pound. So we're really at the center of this global financial system.

ROSENBERG: And more than that even because dollars denominate oil transactions or oil contracts—certainly the benchmark ones—and hundreds of other contracts for oil for delivery at places all over the rest of the world in the prompt month or for future months. What that means is that anyone who's a major purchaser of oil has to do extra legwork to get around, legally, U.S. sanctions.

DOLLAR: So let's take a more recent case, North Korea. This is very high-profile.

ROSENBER: Certainly. Although, Iran is also recent in its newest iteration. We could talk about that too. But North Korea, there's been quite a lot of attention to both the U.S. sanctions on North Korea and the international one. And here again there is a similarity to the Iran case because a history of U.N. Security Council resolutions including sanctions was a basis…has been the foundation for much of the international sanctions architecture and the source of by-in by a number of other countries, most significantly China, to these sanctions on North Korea. The United States, as in the Iran case, has gone far beyond the international sanctions, those U.N. ones, to impose its own restrictions on North Korea. And we saw the biggest ramp up of that at the end of the Obama administration and in the beginning of the Trump administration. And Nikki Haley presided over…worked with counterparts at the U.N. for several new very strong sanctions resolutions with regard to North Korea.

Now, China is so pivotal because it is the lifeline and conduit for the North Korean economy. The overwhelming majority of North Korean financial activity and trade goes through China which is why it's so essential that China be on board with these sanctions. So, the United States has alternately taken the view that it should try and bring China along or force China along by imposing sanctions under North Korea authorities on Chinese entities. And there's been a pause in the sanctions applied to North Korean entities, whether Chinese fronts or strictly North Korean nationals or companies, since the South Korean Olympics. So since the Olympic diplomacy really kicked off there's only been very limited attention to maintenance in that area and we have seen an awful lot of backsliding including as facilitated by the Chinese or Chinese entities or within Chinese territorial waters. There's been plenty of evidence in the press and disclosed as declassified intelligence about illicit ship-to-ship transfers and violation of those sanctions and other forms of violations, but for lack of Chinese pressure and enforcement on North Korea, there's been a degradation of that pressure.

DOLLAR: Right, so the lesson I take from that is each of these countries is quite different. Iran is a major oil exporter. I think it's relatively easy for us to track what's happening with Iranian oil. North Korea is not integrated into the global economy at all. They're a very small player and as you say most of the trade they have is with China. Some of that is just cross-border very small scale. And so, I think this highlights the importance of bringing our partners along, and in the case of North Korea, China has to be a partner to sanctions and to any agreement. Otherwise, it's going to be hard for us to make this work.

ROESNBERG: I agree that that is an important takeaway here. It's not always the emotional reaction that guides U.S. policy or diplomacy, but for sanctions as an instrument—they are not of themselves a strategy—but for them to have utility there has to be a multilateral component whether it's between a smaller group of like-minded countries or at the U.N. level.

DOLLAR: So I think that's a good segue to coming back to Iran and the current situation because we had an agreement. Probably best if you explain what's happened subsequently and what are these contemporary Iran sanctions about.

ROSENBERG: Well actually just about a year ago—almost exactly to the day—President Trump announced what had been a long-standing promise of his: To withdraw the United States from the Iran nuclear agreement. And in doing so, he made clear that the full force of the U.S. sanctions would come back into play. He gave a six-month lead time for those most aggressive energy sanctions to start tightening over time and in November that would be a major step forward for this pressure as the United States withdrew and was beginning to re-isolate Iran in the international system.

And what is notably different about this last time around is that the United States is acting alone. It doesn't have that international coalition it built up that got all of these parties to the JCPOA and a negotiated collaborative diplomatic process. And what is remarkable about the economic pressure, this is a kind of natural experiment that the United States is running about how effect these sanctions are when the United States acts unilaterally and when it applies what we call secondary sanctions. So they're not just on Iranian entities, they're on anyone who's going to do business with Iran. So who is that? It's definitely China – we've been talking about that. It might also be Europeans or Northeast Asians, treaty allies of the United States, the closest security allies of the United States. They are NATO members and Five Eyes partners. This means making our closest allies the leverage for getting after Iran.

And just at the beginning of May there was another step increase where in this pressure strategy where the United States indicated to all of the last remaining purchasers of Iranian oil – includes China, India, Turkey, several others – that they would have to get to zero immediately. Stop buying Iranian oil. So this is unprecedented. Now, even in that maximum pressure era of Obama era sanctions on Iran with the coalition of countries involved these same hold out or core purchasers of Iranian oil never had to get to zero. They had to reduce by about 20 percent every 180 days, but they hadn't been pushed to zero. Here, they're being told to go to zero. So we're going to see what this means for the strength and the efficacy of U.S. sanctions both by the numbers and by perception.

DOLLAR: So do you have a prediction of what the likely outcome is?

ROSENBERG: I do. My prediction is that there will be a strong compliance and market response this month, in May, where some of those biggest traders and refiners that import Iranian oil will indeed get pretty far out of the Iranian oil buying business. They're going to go, if not to zero –some of them can get to zero—they're going to go as low as they can. And that includes some of those biggest Chinese refiners and energy companies. But, I don't think it will last, and Iranian oil will not stop flowing. And we will see — again in this natural experiment — the rise of a new class of commerce, new smaller — not necessarily new though that will be part of it — but also smaller traders, smaller refiners, smaller purchasers who are interested in getting into this game or taking a bigger role and what is smuggling and sanctions busting, but because they can operate far away from U.S. jurisdiction they may be able to operate notwithstanding being targeted by sanctions. And there's some precedent for that. A company can operate, can purchase and refine oil, under U.S. sanctions and it doesn't matter so much.

DOLLAR: Right. So as I understand it there could be some smaller companies or start-ups that could do the shipment of the oil and other things we're finding is obviously important. And as you say if the big majors in China both the oil companies and the banks stay out of this then they're going to avoid U.S. sanctions. But you may end up having some smaller companies that we either can't identify or we identify them and we sanction them but they can do a certain amount of business outside.

I think we should qualify a little bit of what I said earlier that access to the dollar system is a huge benefit, but it is possible to have barter exchange there possible to get around it. I would argue mostly on a relatively small scale, but that can add up to fairly significant and exports for Iran.

ROENBERG: Right, well this is what's important. There are barriers to scaling if you have to resort to terribly inefficient barter or triangulation of value. If you have to manage your business and suitcases of cash for example or cargoes of something you really have to sell on to reap value from you're taking a big loss on it. But there will still be people…there will be economic incentives nevertheless to do that kind of business and the question for U.S. policy objectives with regard to Iran comes down to: Will Iran be able to access enough hard currency to be able to hang in there and possibly wait out the Trump administration. Or, under economic pressure and backed into a corner once again, will they take some other action whether it be a kind of pushback and provocation including by restarting some of its nuclear activities which Iran has said it will begin to move towards slowly or by engaging in negotiation or capitulation which is surely what the Trump administration is hoping for.

DOLLAR: I mean some of the countries that are unhappy about the US pulling out of the U.N. agreement—some of our European partners and China … probably Turkey and India whom you also mentioned—there's talked a little bit about finding some kind of work around...more formal payments mechanism. Do you see much prospect for that?

ROSENBERG: Not in the short term. In fact, the greatest significance is as a political message to Iran that in the case of what's called “INSTEX” or the special purpose vehicle that the UK, France, and Germany have been working to launch, they are signaling to Iran that through this non-bank financial platform they will help to facilitate what will be humanitarian transactions between entities in Europe, possibly elsewhere, and Iran. There's a whole array of problems with that entity that are part of what have caused it not to fully launch yet. And the problems aren't just in Europe for a lack of companies who want to get involved in that. If they do want to they don't actually need that. It's all legal under sanctions that kind of humanitarian trade: food, medicine, medical devices. And there are problems with the special purpose vehicle on the Iran end. They have some more mechanics to work out before that's really going to work as a as a vehicle for transferring value. But, this is a kind of beta testing. It may be unsuccessful, but the countries involved in it will learn for a potential next time.

And there are other models going on. China is contemplating some of its own, Russia is contemplating some of its own payment messaging systems or value transfer systems that get away from U.S. jurisdiction and away from the kind of payment messaging that is centralized in Europe but is extremely exposed to the U.S. legal system.

DOLLAR: Right. So there are quite a few countries that are unhappy about this unilateral approach to the United States talking about setting up alternative payment mechanisms looking for ways...I share your sentiment that in the short run this is all likely to be very small potatoes and just highlights where we started that the U.S. has this tremendous power because of the special role of the U.S. financial system and the U.S. dollar in the global system.

I would also add that in China they love to talk about internationalization of their currency, the Chinese yuan, and they complained about dominance of the U.S. dollar. But I think that's pretty far away in the case of the Chinese currency because they still have a closed capital account –or are very, very partially open capital account—so it's hard to move money in and out, hard to switch easily from any currency into Chinese money.

And then probably more importantly, part of our success is we have these deep capital markets in the United States. So one reason people use the dollars is holding dollar assets as reserves makes sense because if you need to use them you can always go into our deep markets and convert Treasury bonds into cash for example. In China it's much more difficult to operate in the capital markets. So the Chinese aspire to have this internationalization of their currency. I think it's pretty far away.

ROSENBERG: Right. Many international economists would look at this Chinese example and some other Russian efforts or the ill-conceived poorly-executed Venezuelan effort at a crude-backed cryptocurrency, that petro, and dismiss them for some of the reasons you mentioned and others. What's interesting about the INSTEX, the European special purpose vehicle, is that this is the first time that Europe has really made a push towards exploring this idea. And actually within the EU since the end of last year there's been a greater portion exploration of internationalizing the euro and trying to encourage further commerce including commodity transactions to be denominated in the euro. They have lots of work to do before that would really chip away at the market share for the dollar, if you will, amongst currencies or as stores of value, but nevertheless people observing this currency universe could believe that the euro has the greatest potential if a lot of big questions could be addressed to edge in on the dollar. And it's easy to think that won't happen, but thinking back to the transition from the sterling to the dollar, it looked unlikely and then it happened all of a sudden. So, looking forward is that could that happen?

DOLLAR: I think you're absolutely right that the euro has got the best chance of becoming a more significant global currency in the near-term. Right now 62 percent of global reserves are held in dollars. And that's actually been a very, very stable percentage over decades. I think about 20 percent of global reserves are held in euros. So they're number two, and that suggests they have some potential, but I think the problem there is a lot of people lack confidence in the euro and more fundamentally they lack confidence in Europe. Britain is not part of the euro, but Brexit just reminds people that the whole European project is somewhat risky. And then, you don't really have a single deep capital market. So you have euro denominated bonds from Germany, from Italy, all the other Euro countries. They're all treated as quite different instruments and capital markets and that means that no one of them really has that deep market. So, they've got the best prospect to hang on as number two, but I think the U.S. would really have to stumble in order to see the euro overtaking the dollar in any meaningful sense.

ROSENBERG: So there's an interesting public policy question we should ask ourselves when looking at this picture you just painted which is should we be reassured that the dollar and U.S. economic primacy is on top then and stable—even inevitable? Should we take away from that that these instruments, these sanctions instruments, that are premised on so much of that policy will stick around and we can use them for anything we want? Going forward, we're going to make our partners and allies and adversaries the, unwilling often, foot soldiers of U.S. policies?

Well it looks to me like for the near-term into the medium-term, yes. The United States does have that power and authority and there'll be no alternative. The question is just at some point in the future will there be another likely currency that will undermine the dollar strength enough that that these sanctions will lose some of their efficacy? And, will the United States commit an own goal in order to also tip that balance which is possible?

DOLLAR: Right. I mean I definitely think we should learn the lesson of what's led to this dominance of the dollar which is things like property rights and rule of law. People have confidence in our legal system. They have confidence in our capital markets which are which are quite deep. So I think we need to always be tending to the institutions that are at the heart of that power. The question I want to ask you, which will be our last question and probably comes directly out of your report, is are we overusing these sanctions? And what do we need to do to preserve this instrument as something that's useful for diplomacy but is not overworked.

ROSENBERG: Right. So there's a healthy debate right now about whether we are overusing these measures. If we assume that the United States will have this dollar primacy for some years to come, then should we be concerned about overuse? So there is a robust debate, there should be robust debate, more people should get in on this robust debate, and we should introduce some important questions which are even if the United States will continue to have this primacy should, we nevertheless be focused rigorously on making sure that that is stable and sustainable and being aware of other factors yet unknown that may undermine it in the future. For example, do we have a really good grasp of how financial technology or fragmentation in the global trading system and financial services world will influence the strength and availability of U.S. sanctions and the strength of the dollar?

I feel concerned about this future path and concerned enough to have made a number of recommendations with some of the people I've worked with and in the past including on the most recent report that we released. It's essential for the United States to do a lot more than it's doing to understand the effects, the economic effects and financial effects, of the use of these instruments. I think it's quite poorly understood which is one of the reasons why policymakers reach for it all the time and all kinds of cases. We've only talked about a couple of different sanctions cases but there are other big ones targeting other major economies like Russia and China and exploration of using these measures towards Chinese entities that could have very big effects both in domain or direct in the financial services sphere or otherwise across other domains.

So understanding them better, resourcing appropriately the offices of the U.S. government that study the effects, that put together designations packages, that conduct enforcement, and significantly that coordinate between different offices or agencies of the U.S. government that have overlap where there is an overlapping signaling or effect. So for thinking about China, there is, I would argue, poor coordination between the people who are working on trade remedy and commerce actions, trade deal, law enforcement around sanctions violation or export control violations along with advancing Iran policy which has a strong China angle we've discussed. North Korea policy also has a strong China angle. To say nothing of concerns about targeting those who press Uyghurs with ... authorities or Chinese fentanyl imports into the United States with … authorities. There's no coordination going on and I fear that that will pose a detriment to U.S. credibility, to the efficacy of its policy and messaging, to its ability to work with foreign counterparts and allies where there is shared policy concerns and values. Where these sanctions policies come into play and where other factors, other policies related to trade, investment security, law enforcement, are the tools of choice.

So those are some of the concerns I have. I've also talked a lot about the financial technology steps the United States should take to try and incentivize more innovation and support more innovation in the United States. There's a regulatory component, there's a financing component, there's a big security component around data, and I think that's part of this too.

DOLLAR: I've been talking to Liz Rosenberg, senior fellow at the Center for a New American Security, and she's helped us understand the prime role of the U.S. financial system in the U.S. dollar in global trade – how that's the basis for the US to apply sanctions to pursue diplomatic ends. We talked about the Iran and North Korea cases in particular and then I really appreciated your last couple of comments about the risk of overusing this tool and not thinking through clearly what are we doing with this tool and what are we probably not want to do with this tool.

If you want to read more about this go to the CNAS.org website and look at the report co-authored by Liz and her colleagues. Thank you very much.

ROSENBERG: Thank you.

DOLLAR: “Dollar & Sense” is a part of the Brookings Podcast Network. It wouldn’t be possible without the support of Shawn Dhar, Anna Newby, Fred Dews, Chris McKenna, Gaston Reboredo, Brennan Hoban, Camilo Ramirez, Emily Horne, and many more.

If you like the show, please make sure to rate it and leave us a review. Send any questions or episode suggestions to bcp@brookings.edu. And until next time, I’m David Dollar and this has been Dollar & Sense.