Sanctions Run Amok:

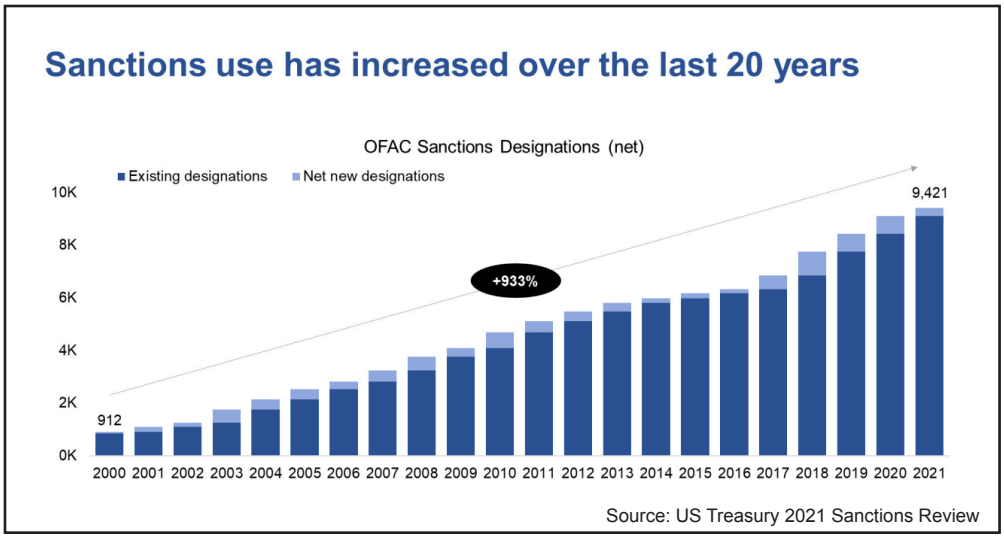
The Undermining of U.S. Power

- By Keith A. Preble

Well into its second year, the Biden administration has continued to grapple with persistent foreign policy challenges while new ones have emerged: North Korea has not curtailed its weapons of mass destruction (WMD) programs; negotiations with Iran on resuscitating the Joint Comprehensive Plan of Action (JCPOA) remain stalled; and a Russian troop buildup near Ukraine may signal a potential invasion and full-scale conflict. In confronting these and other challenges, the United States continues to use economic sanctions as a mean of punishing, signaling, and coercing rivals into changing their foreign policy behaviors. As a tool of American economic power, policymakers often see sanctions as "Goldilocks" instruments that are "just right," albeit ones that require time and patience to facilitate policy change.[212] Like Goldilocks, policymakers often face difficult choices. Military action may quickly bring about desired results but at an extremely high cost, whereas relying on diplomacy alone may be less politically and economically risky but fail to achieve the desired outcome. Economic sanctions represent a middle ground where doing something is better than doing too much or nothing at all. Although their effectiveness remains contested by academics and policymakers, their versatility and perceived benefits makes their use an attractive policy response by the United States in confronting foreign policy challenges.[213]

The United States dominates the global financial system. U.S. economic power both has significant coercive potential and can be wielded unilaterally with few consequences — most countries are unable to challenge the United States's economic might. Moreover, they are comparatively easier for U.S. leaders to implement than other foreign policy instruments, as they can be imposed by the executive branch alone, without congressional approval. Whether by executive order or legislation, the U.S. Treasury Department, via the Office of Foreign Assets Control (OFAC) creates the regulations that guide sanctions implementation. Although other U.S. agencies are also involved in this process, OFAC is responsible for enforcement, administering, and updating the United States's Specially Designated Nationals and Blocked Persons List (SDN), a "blacklist" of entities with whom U.S. companies and individuals cannot do business.[214] The SDN list has grown considerably over the last two decades, a fact highlighted by the Biden administration's October 2021 sanctions review.[215]

The United States's use of economic sanctions since 2000 has grown concurrently with the SDN list. In the early 2000s, 69 U.S. sanctions targeted Cuba, Iraq, Libya, Yugoslavia, and Iran, representing 77 percent of the total enacted amount. By 2021, the number of American sanctions programs more than doubled to 176, with 53 percent targeting six states: Iran, Iraq, North Korea, Russia, Syria, and Venezuela.[216] With the explosion of U.S. economic sanctions imposed on countries and entities, the Biden administration has recognized the need to recalibrate how they are employed and the resources necessary to manage such commitments.



The October 2021 sanctions review conducted by the U.S. Treasury Department highlighted the need for changes in the use and implementation of economic sanctions through a series of "five steps:" adopting a structured policy framework that links sanctions to clear policy objectives; incorporating multilateral coordination when possible; calibrating sanctions to mitigate unintended economic, political, and humanitarian impacts; making sure sanctions are easily understood, enforceable, and adoptable; and making investments in the Treasury's sanctions technology, workforce, and infrastructure.[217] Paradoxically, as U.S. administrations have come to rely on economic sanctions as a critical policy tool for responding to foreign policy crises, the level of material support for the Treasury has not grown concurrently.[218] Yet these resource problems are only the tip of the iceberg as the United States grapples with efforts by allies and adversaries to evade and mitigate the impact of U.S. economic sanctions. For economic sanctions to be successful, U.S. foreign policy must work in tandem with other forms of economic statecraft while providing U.S. agencies with the appropriate level of resources to achieve desired outcomes.

As Stephanie Zable rightly points out, disdain for the United States's sanctions regime began long before the Trump administration's "maximum pressure campaign" and the "sanctions wall" against Iran touted by Secretary of State Mike Pompeo and others in the former administration.[219] As America's use of economic sanctions has increased, U.S. allies and adversaries have sought ways to avoid them. The Helms-Burton Act of 1996 — officially known as the Cuban Liberty and Democratic Solidarity (LIBERTAD) Act of 1996 — first introduced the concept of extraterritorial and secondary sanctions.[220] U.S. economic sanctions programs against Iran and Cuba were failing to achieve their goals as European countries, Japan, and Canada maintained strong commercial ties with these traditional American adversaries.[221] To combat noncompliant firms whose trade with U.S. adversaries undermined U.S. foreign policy, the United States expanded the scope of "primary" sanctions by developing "secondary" sanctions. Primary sanctions restrict economic engagement between firms in the sanctioning state and the sanctioned state. Secondary sanctions go further: they are designed to disrupt and impede economic relations between the state targeted by economic sanctions and its trading partners (third-party states), following the logic that these disruptions improve the effectiveness of primary sanctions. American secondary sanctions may also impose restrictions on U.S. citizens and firms from doing business with firms in third-party states that continue to deal with firms in the sanctioned country. Legally, they become extraterritorial when the United States imposes fines and other remedies against firms in third-party states.[222] The employment of even a single American by a foreign firm is often enough to trigger the extraterritorial application of secondary sanctions against thast firm.

While the United States backed off enforcing Helms-Burton's extraterritorial provisions after it sparked a diplomatic firestorm between itself and Europe, changes to regulations in the second half of the George W. Bush administration led to a massive increase in the maximum fines permissible under U.S. law in 2009.[223] These changes provided the Obama administration with a potent financial weapon to operationalize against firms advertently or inadvertently undermining U.S. economic sanctions. As U.S. foreign policy prerogatives shifted from Cuba to Iran, the United States wielded these new powers with particular strength against major European financial institutions for violations of Iran sanctions programs (among others). In one instance, U.S. fines approached almost USD 1 billion.[224] Banks based in the EU had few options but to comply given their reliance on the American financial system.

These huge fines accomplished their goal and served as powerful deterrents, at least in the financial sector, as banks became more cautious. Financial penalties, as well as a ratcheting up of sanctions and the United States's departure from the JCPOA, came together to create an atmosphere of overcompliance whereby banks and other companies found it cheaper to exit targeted markets than to continue business there. Accordingly, the United States's lack of support for the JCPOA and the attendant negative impacts to its own firms demonstrated to the EU that it had to exercise greater resolve in countering U.S. flip-flopping on a deal that was largely working and one that the Trump administration had initially certified.

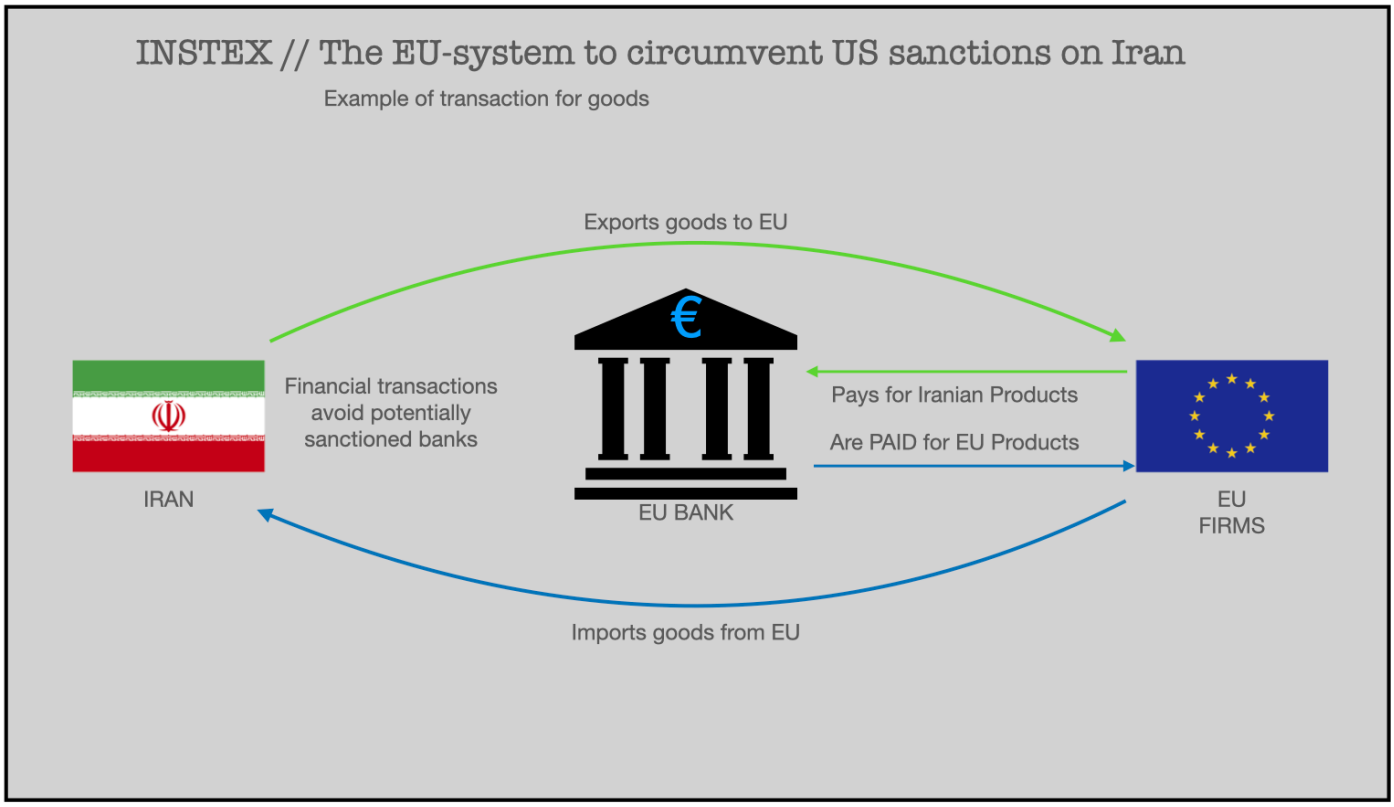
As American foreign policy increasingly relies on sanctions, regulators tasked with their enforcement face internal resourcing challenges while simultaneously

working to mitigate external challenges to their effectiveness as allies and adversaries seek to undermine their impact. The overuse of economic sanctions has motivated allies and adversaries alike to find ways to avoid the U.S. dollar and banking system. Such an eventuality would make compliance and enforcement extremely difficult for OFAC, as the United States is unable to go after every single violator.[225] Today, one of the foremost challenges the United States faces in achieving its sanctions' desired effect comes from blocking regulations developed by the European Union in the early 1990s. These were intended to find ways to avoid violating U.S. economic sanctions and were resuscitated during the Trump administration.[226] Eventually, they were transformed into what the EU has called the Instrument in Support of Trade Exchanges (INSTEX), a special-purpose vehicle designed to facilitate humanitarian trade with Iran.[227]

Special-purpose vehicles are common in business and are created as subsidiaries of parent companies to hedge risk. Should a risky business venture fail, the failure remains confined to the subsidiary and limits the risk to the parent company. INSTEX is a unique special-purpose vehicle that is not backed by a single parent company or the firms utilizing INSTEX for trade. Instead, the transactions are ostensibly guaranteed by the EU member states and European countries that developed it. As of the writing of this piece, INSTEX has ten shareholders: the original "E3" — France, Germany, and the UK — along with Belgium, Denmark, the Netherlands, Norway, Finland, Spain, and Sweden.[228] With the backing of ten European governments with significant financial and economic resources assuming the risk of firms using the SPV, INSTEX represents a unique effort at mitigating the impact of U.S. economic sanctions.

Yet INSTEX is not simply a mechanism for saving the JCPOA, but rather reflects a response to Europe's need to balance U.S. economic dominance credibly when that dominance runs counter to EU interest or when the United States and EU are unable or unwilling to find common ground regarding foreign policy.
In June 2021, the Biden administration and its EU counterparts held a virtual summit that addressed the issues of economic sanctions and the need for greater coordination in using economic sanctions, both of which are reflected in the Biden administration's September 2021 economic sanctions review.[229] By working with allies on the imposition and enforcement of sanctions, Washington can preserve a critical policy tool on which foreign policymakers rely. The need for improved cooperation in the use and enforcement of economic sanctions may slow the development of SPVs and other bartering systems that have potential to undermine U.S. economic dominance and further undermine the effectiveness of economic sanctions.

Surprisingly, INSTEX has received little public attention from U.S. regulators as EU officials have sought to develop a mechanism that would keep the JCPOA alive and maintain Iranian compliance with the agreement



while providing assistance to firms seeking to avoid potentially staggering fines for violating U.S. economic sanctions.[230] Although it has largely been dismissed as insufficient to challenge U.S. economic dominance in the international system, U.S. policymakers and regulators should worry because it represents a nascent effort at avoiding coercive American economic policies and is bound to spread.[231] While the EU has couched efforts at developing INSTEX around the preservation of the JCPOA, it would be naïve for U.S. policymakers to ignore the realities of these instruments. In hedging its bets for the future, the EU may see INSTEX as a new tool for countering U.S. efforts to impose secondary and/or extraterritorial sanctions again its firms.

Within the INSTEX framework, EU firms can import and export goods from a sanctioned state, but the payments flow between the importing and exporting EU firms rather than between EU and sanctioned firms. A complementary SPV would exist in the sanctioned country. Like INSTEX in Europe, the sanctioned country's SPV would be backed by its respective government and any other potential members that may participate, allowing for payments to be transferred between firms in the sanctioned state in exchange for EU goods.

For example, imagine that an Iranian hospital wishes to purchase antibiotics from a European pharmaceutical company. Because of sanctions against Iran, the European pharmaceutical company might potentially cancel the order because neither the company, nor potentially its bank, is willing to undertake the costly regulatory burdens to clear the transaction with OFAC, deal with the political risk and uncertainty of trading with Iran, or shoulder the risk of fines. Through INSTEX, the EU pharmaceutical company has a new option: rather than receive payments from the Iranian hospital that might run afoul of U.S. sanctions regulators, the exporting EU pharmaceutical company can use INSTEX to find another European firm seeking to import goods from Iran, such as a European food distributor importing pistachios from Iran at a similar cost to the exported antibiotics. The EU food distributor importing pistachios from Iran pays the EU pharmaceutical company seeking to export antibiotics to the Iranian hospital. Financial transactions do not involve potentially sanctioned Iranian banks but instead remain in Europe as the payments are exchanged between the EU pharmaceutical manufacturer and the EU food distributor via the SPV.

In Iran, a similar system exists: the Iranian hospital would pay the Iranian pistachio supplier for the pistachios provided to the EU food distributor. Key to avoiding U.S. sanctions is the fact that financial transactions in Iran do not cross borders beyond the reach of U.S. regulators. The Iranian SPV between Iranian banks facilitate payments. Only the goods exchanged — antibiotics and pistachios — move across borders. Ideally, the SPVs in the EU and Iran would then clear funds for payment only after the goods in question have arrived at their respective destinations.

INSTEX thus makes it exceedingly difficult for OFAC to target violators as it cannot justify punishing banks for financial transactions that occur entirely between European or Iranian firms. OFAC could attempt to sanction logistics agents, shippers, and other entities involved in international trade, but doing so would require significant additional information; international trade involves a host of actors, many of whom conduct legal business activities; tracking, so punishing suspected violators requires time, resources, and, most of all, intergovernmental cooperation. More aggressive sanctions enforcement by OFAC would risk injuring legal commerce by U.S. allies, potentially undermining both U.S. economic and diplomatic interests. As it stands, OFAC lacks the resources necessary to oversee existing sanctions programs; adding additional burdens in identifying hundreds of barter-and-exchange transactions would be exceedingly cumbersome.[232] How would OFAC sanction a shipping company or a single vessel that might hold containers not just to Iran but also to a multitude of other destinations throughout major shipping routes around the globe? Given the Treasury's lack of resources and its reliance on voluntary compliance over the last several years, the prospects of a fully functioning barter-and-exchange mechanism beyond the reach of American law should worry U.S. regulators.

The European Union has not pursued INSTEX beyond the exchange of humanitarian goods, having completed the first transaction between Europe and Iran in 2020 with the delivery of exported medical supplies.[233] While only a few exchanges have occurred between the EU and Iran, the system has room to grow. A marketplace could be developed through INSTEX and counterparts in sanctioned countries where buyers and sellers using the SPV compete for barter and exchange opportunities. Returning to the previous pistachio and antibiotic example, imagine a situation where there is an imbalance between the value of the pistachios and antibiotics. A hospital in Iran might be in a position where it cannot purchase more or is unable to reduce its order due to medical necessity. A pistachio farmer may have lower yields, or market prices of pistachios may fluctuate making the trade more expensive than originally anticipated. In a fully developed exchange, a third or even fourth firm in the EU and/or Iran could participate to offset trade imbalances that might arise. As the exchange grows and more countries and firms participate, the risk of imbalances hindering the system become less problematic.

As more countries sign onto INSTEX, the marketplace would be expected eventually to include exchanges of non-humanitarian goods. With EU governments shouldering the trade risks, exporting firms within the European Union and any other country willing to accede to INSTEX's regulations have much to gain and little to lose. INSTEX could potentially open markets that are closed not only by sanctions, but also by the difficulties

in securing export credit to facilitate trade. Although the EU has been cautious in managing INSTEX to avoid disrupting transatlantic relations, Chinese and Russian versions of these exchanges operating with their SPV counterparts in sanctioned states — like Iran or Venezuela — would presumably be less amenable to U.S. interests. These types of markets, while initially cumbersome, could become more efficient and effective over time, especially if they are profitable and stimulate competition and economic growth.

The humanitarian impact of American economic sanctions has been well documented.[234] While INSTEX has been marketed as a mechanism for facilitating delivery of humanitarian goods to Iran, it alone fails to explain the development of the special purpose vehicle developed by the E3 — the United Kingdom, Germany, and France.[235] Trade in humanitarian goods to Iran represents a small fraction of overall EU trade, but the use of humanitarian goods in developing and testing INSTEX may provide space for the exchange mechanism to further develop to include other types of goods while avoiding potential sanctions by the United States. The real danger to U.S. interests lies in further growth in INSTEX's membership and the potential granting of a banking license, which would allow INSTEX to extend credit and provide trade financing and services to facilitate intrastate financial transactions banks may fear to undertake.[236] INSTEX may represent the first of many SPVs that could potentially develop in response to U.S. sanctions, serving as a blueprint that tests the limits of U.S. economic power by forcing U.S. policymakers to make tough choices to preserve U.S. economic dominance. While still in its infancy, the use of SPVs like INSTEX represent a movement that, if sustained and largely successful, would prove detrimental to U.S. foreign policy.

INSTEX is an example of how economic sanctions create potentially lucrative opportunities. When U.S. economic sanctions returned to pre-JCPOA levels after the United States left the agreement, U.S. companies once again became largely prohibited from engaging with Iran. These developments have again created a commercial vacuum in which EU, Russian, Chinese, and other third-party firms can profit from the reimposition of unilateral American economic sanctions. While the climate of fear generated over time due to previous sanctions continues to impede economic relations with Iran, INSTEX member states could envision a marketplace for exchange unhindered by overcompliance.[237] As INSTEX develops, firms in third-party states, especially those from smaller countries who may be unable to take advantage of commercial opportunities with sanctioned entities without fear of U.S. sanctions, could partake as additional governments join to support INSTEX. By opening exchange to countries outside the EU, trade and barter could expand the scope and scale of traded goods and participating firms.

Although INSTEX represents a long-term challenge to U.S. sanctions policy, it has been downplayed by U.S. administrations. While INSTEX's fledgling nature makes it unlikely to be an immediate direct threat to the United States's use of economic sanctions, EU efforts have already set the stage for the development of competing barter and exchange mechanisms by China and Russia, which, if successful could eventually limit the United States's ability to wield sanctions.[238]

Our understanding of INSTEX has been limited by its framing as being merely a vehicle for humanitarian aid. Most significantly, INSTEX has the potential to complicate U.S. sanctions enforcement. Moreover, the manner in which the development of this SPV stood up to the Trump administration's wanton use of economic sanctions has emboldened U.S. allies and adversaries alike to seek ways to circumvent U.S. economic sanctions. As the Biden administration reconsiders its use of economic sanctions from the previous administration, American policymakers should

take the development of SPVs and barter-and-trade systems more seriously, rather than relying on sanctions or threats of sanctions to counter their potential or their ability to undermine the United States's economic power. While the United States only threatened to sanction INSTEX, it is unclear whether those sanctions would have been effective or worth the cost of upsetting longstanding transatlantic relations with Europe and quickening the development of these systems of exchange.

Economic sanctions work best when they are paired with other tools of economic statecraft and allocated the necessary resources to be properly managed, implemented, and enforced. Half-measures, idle threats, and an unwillingness to pursue diplomatic engagement will only embolden the EU if, and when, future American administrations re-attempt a unilateral return to "maximum pressure" campaigns against perceived enemies. Instead of furthering U.S. foreign policy interests, such actions may backfire and provide adversaries with blueprints for evading U.S. sanctions and undermining the full potential of U.S. economic power.

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