Observations on Financial Sanctions
by Roger W. Robinson, Jr.
21 March 1996

Background

In the past, nonproliferation sanctions in the financial arena generally involved the curtailment of US assistance flows, constraints on official lending programs (e.g., Eximbank) and, more recently, restricted access to US private sector financing (e.g., India's nuclear test case). Nevertheless, since financial penalties entered the arsenal of US responses to foreign policy/national security challenges in the 1970s, the Department of the Treasury, the Federal Reserve and other economic agencies have had serious reservations concerning the use of such measures -- almost independent of the scale of the foreign policy offense. The principal rationale for this opposition was and is that any sort of unilateral US capital controls could ultimately inhibit the free movement of funds into and out of the United States and have a potentially disruptive impact on global, currency and equities markets.

The luxury of eschewing financial sanctions, however, is no longer affordable given the ominous consequences of WMD and ballistic missile proliferation activities. Accordingly, the challenge is to structure a flexible and creative menu of such sanctions which have the desired effect of deterring proliferation and, failing that, can be incrementally applied with as little disruption to the international financial system as possible. Although a good deal of additional research is required on this subject, some initial observations might be useful:

Diminishing returns from use of sanctions -- Given the prodigious speed and diversity of global markets, the actual implementation of financial sanctions against violators would likely discount somewhat the effectiveness of the future use of such sanctions, particularly those involving the private sector. For example, potential adversaries would quickly take note of any such precedent and likely institute elaborate safeguards. Western lenders and traders would likewise seek ways to circumvent the possibility of future cutoffs in the interest of reliably servicing valued clients. As a result, the principle purpose of incorporating financial sanctions in any legislative compliance regime should be one of deterrence.

Incrementalism is probably the way to go -- The problem with most financial penalties is that they tend to be an all or nothing proposition. For example, in the case of China, Beijing's proliferation activities with regard to Pakistan would properly entail a loss of all access to US Eximbank facilities. The politics of some $10 bn. in US exports and related jobs at stake probably inhibits the willingness of the Executive Branch to use such measures on a sustained basis and, thereby, reduces the latitude of US action. The loss of a portion of such Eximbank availability in the event of proliferation violations would perhaps provide a better disincentive to such activities than a 100 percent shutdown. Among the reasons for this assessment include a more manageable level of political blow-back on the president from the US business community and other interested parties and an effective demonstration of US political will to expand the scope of the sanctions in the interest of deterrence. Naturally, this kind of approach could be applied to a range of both official and non-governmental financing facilities.

Increased sophistication of financial sanctions is required -- A good case can be made for focusing on a broader array of funding methods employed by targeted foreign countries and companies. This is because many actual or prospective proliferators are encountering serious financial and economic difficulties (e.g., Iran, Iraq, North Korea, etc.) that are not entirely unlike that of the Soviet Union prior to its collapse. These states generally have limited means of attracting money. In this connection, I can offer two illustrations of financial instruments that might be included in a sanctions regime.

The first involves curtailing the access of violators to the US securities markets. Proliferators have a substantial interest in expanding their international borrowing opportunities, and the issuing of bonds and/or shorter-term notes provides two major benefits: 1) Issuing securities can be an inexpensive way to obtain large sums of untied, general purpose cash; and 2) The many different US and Western subscribers to such bond or notes (including securities firms, pension funds, corporations, leasing firms, individuals, etc.) can be potentially recruited into serving as new constituencies to thwart any future US sanctions which could have the effect of causing the borrower to default on these obligations.

The former Soviet Union, for example, made a serious stab at issuing a total of some $1.8 billion in bonds in several allied financial centers between 1985 and the Soviet demise in late 1991. From Moscow's prospective, the proverbial jewel in the crown of being accepted in the global securities markets was the ability to float a successful bond issue in the United States. Although no direct US Government action was taken to deny Soviet access to the US securities market, this issue was "politicized" in the course of Congressional hearings editorials and think tank publications. This effort, along with data disclosure and other regulatory obstacles imposed on Moscow by the Federal Reserve, undermined this Kremlin gambit. As a consequence of this denial, the cost of money to the Soviets in the financial markets was higher, and prospective investors were more skittish than would have otherwise been the case. It may be possible to build on this successful precedent in a more deliberate, legislative context.

A second and new area which proliferators are likely exploiting or wish to exploit is attracting hard currency funds from international banking institutions in the so-called interbank deposit market. Although this area of international finance requires more study, the interbank market involves banks (including those of proliferator nations) depositing funds with one another on a short-term but renewable basis. There are several advantages of violators utilizing the interbank market, including: 1) It is possible to obtain a great deal more hard currency from Western banks than the proliferator bank would put on deposit with them; 2) The funds represent unfettered cash (i.e., tied to no specific purpose like a project or trade transaction); 3) The sourcing of the funds can be blurred by the non-transparent nature of this market; 4) It is often cheap money; 5) Deposits can be repeatedly renewed (e.g., like the rolling forward of a six-month CD) and can, thereby, be transformed into a medium-term financing facility; and 6) Proliferator banks can successfully construct and reinforce relationships with Western banks which facilitate more borrowing options for the proliferator-owned institution in the future.

Accordingly, it is no wonder that the official foreign trade banks of countries like Russia and China have some 2000 or more correspondent bank relationships around the world as well as foreign subsidiaries largely dedicated to attracting interbank deposit money. A US sanction which disrupts the ability of violator nations to engage in interbank activity with US institutions here and abroad could send a chilling signal through the global markets and ultimately lead to a significant short-term liquidity squeeze affecting these nations.

Summary

Although these initial thoughts are quite general, they do point to a need to take an inventory of the various instruments and lending facilities in the marketplace available to violators and evaluate what possibilities, if any, exist to inhibit access to such facilities. In this connection, it may be useful to task the Treasury Department and the Federal Reserve to provide relevant committees with a comprehensive list of all sources and uses of hard currency for each suspected proliferator nation. In addition, the various borrowing methods of each country should be obtained as well as a list of all so-called correspondent banking relationships.

Similarly, various strategies could be examined concerning an incremental ramp-up of financial sanctions which could improve the flexibility and usefulness of such sanctions. Finally, in cases where vital US security interests are at risk, a debilitating combination of more draconian official and private sector financial sanctions could be configured, but probably on an infrequent or "one shot" basis.