Economic Destruction of States in the World of Global Capital Markets

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Abstract

Economic sanctions are supposed to be an alternative to the horrors of destructive armed conflicts. They were designed by American policymakers to generate significant economic costs for a target country, thus forcing it to produce a desired policy change. In recent decades sanctions have acquired a prominent role in the national security strategy of the United States and its allies as an efficient tool to advance their political goals. The ongoing intersection of this mechanism of economic coercion with globalized capital markets provokes three major lines of criticism. First, many analysists remain highly sceptical of the "persuasive" effects of sanctions. Even under close monitoring it is still possible for target regimes to circumvent any restrictions. Second, it is a country's population that suffers most, as coercive economic measures are more likely to impoverish innocent civilians than to yield significant political concessions. Third, "the weaponization of finance" undermines the undisputed hegemony of the United States in global capital markets and triggers diversification away from U.S. dollars.

Key words: targeted financial sanctions, reserve currency, trade embargo, economic restrictions, target economy, economic coercion

The rise of targeted financial sanctions

The United States has a long history of economic sanctions. In December 1807, the Congress passed the Embargo Act with the strong support of the Jefferson administration (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). This is considered to be the first American sanctions aimed at punishing Great Britain and France for impressing American sailors during the Napoleonic wars. However, these measures failed to generate any economic costs for the target countries and hurt instead the US economy. The sender frustrated by self-inflicted wounds and terminated the Embargo Act less than 18 months later. Economic sanctions as a new tool of warfare were introduced by U.S. President Woodrow Wilson after the

catastrophe of the World War I (Hufbauer, Shott, Elliott, Oegg, 2009). He supposed that economic coercion could be as efficient as traditional military campaigns but less hazardous in terms of civilian suffering. By the advent of globalization of commercial markets and the growing demand of policymakers for non-military options the U.S. significantly altered the use of coercive economic measures. These considerable innovations made them more potent and cost-effective as opposed to the Jefferson's failure. The following paragraphs set out the evolution of economic statecraft from trade embargoes to targeted financial sanctions.

Before the dawn of the 21st century the conventional wisdom emphasized the futility of economic sanctions. The post-1991 Iraq sanctions failed to prevent Saddam Hussein's regime from acquiring weapons of mass destructions which was the major aim of the arms embargo. In the long run this led to the notorious 2003 invasion of Iraq (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). In the 1990s Robert Pape wrote the most-widely cited article on the coercive economic measures entitled "Why Economic Sanctions Do Not Work". He stated that only in 5 percent of cases sanctions managed to produce a desired policy outcome (Pape, 1997). Gary Hufbauer and Jeffrey Schott, who served in the U.S. Treasury Department, made a set of 174 sanctions cases and calculated the more optimistic 34 percent success rate (Hufbauer, Shott, Elliott, Oegg, 2009). However, the policy consensus in Washington was clear: sanctions did not work.

Over the past 20 years policymakers became more enthusiastic about economic sanctions as the ultimate effects of targeted measures on Iran and Russia were tangible enough. Indeed, the 2015 Joint Comprehensive Plan of Action demonstrated that the utility of sanctions exceeded expectations and extracted even more political concessions from Teheran. The modern political landscape in the United States is dominated by the Department of the Treasury. According to the former deputy security advisor, it has replaced the Department of Defense in terms of confronting U.S. national security threats. What has changed over the past two

decades? The answer consists in the prevailing definition of sanction policy which is nowadays associated with targeted financial measures. This, however, was not always the case (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016).

Targeted financial sanctions were designed to address two major problems. The first problem was upgrading sanctions so that American policymakers could mitigate the negative effects caused by comprehensive trade embargoes. In practice trade sanctions often created negative humanitarian impact on a country's population and the set of restrictions on Iraq is a blatant example. A wide swath of U.S. policymakers devised sanctions under the theory of "brute force" which implied that the greater the economic damage generated for a target, the more likely the coercive measures would lead to political concessions. The U.N. Security Council sanctions imposed on Iraq in the 1990s were so far the most devastating in history. Measured in terms of pure economic loss, they cost Iraq half of its GDP. According to the approximate estimates, the country lost about $250 billion in potential petroleum revenue. Over the first five years of the trade embargo the price for food products rocketed up to 250-fold (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). The second problem was the correlation between the sanction regime and the rapid spread of corruption judging by the U.N.'s oil for food scandal. The mentioned problem triggered a movement towards alternatives to traditional coercive economic measures.

In the 1990s sanctions authorities were preoccupied by the challenge of tackling the problem of narco-traffickers in the Latin America and terrorists destabilizing the Middle East. These developments paralleled the discussions of scholars who noted that sanctions targeted specifically at ruling elites would be more "persuasive" and more compassionate. The so-called smart sanctions were supposed to hit a target regime's winning coalition while sparing a target's population from negative humanitarian outcomes which often followed comprehensive trade embargoes. These measures encompass the following economic restrictions: travel bans, asset freezes, arms embargoes, and limited

import of luxury goods. However, smart sanctions stimulated economic rent seeking which, in turn, strengthened the position of key elites. As a rule, a target government seeks third parties for its international transactions. Then they set up a company under a name which is not yet blacklisted and seek brokers to contract suppliers and pay for illegal imports to further blur the traces of transactions (Yagizi, 2014). Every stage generates its margins resulting in the profits for brokers and increasing overall prices for products. Thus, economic restrictions enable the supporters of a target regime to enrich themselves at the expense of an already poverty-stricken population.

This innovative approach towards the policy of economic coercion was met with harsh criticism. In practice, the trouble with smart sanctioning was that it seemed to be less efficient at generating required policy outcomes because of the problem for which they were devised: targeted sanctions did not impose significant economic costs. Many scholars arrived at the conclusion that the initial optimism expressed among U.S. decisionmakers was a delusion, and the ultimate results of the U.N. measures, with the exception of Libya, were poor. However, subsequent research revealed that during the Cold war *targeted financial sanctions* were not only successful but also lasted for a shorter period than traditional non-financial restrictions (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). In contrast to the latter ones even the treat of imposing these measures often led to changing anti-money laundering regulation and combating corruption. In practice, financial repression can seriously affect not only those countries with complex financial sectors but also less financially developed economies as the cases of Zimbabwe, Sudan, and Somalia made it clear.

Daniel Drezner, an American professor of international politics, argues that this is the golden age of economic statecraft and the domination of capital. That is why economic coercion in the form of targeted financial measures was warmly embraced by U.S. policymakers (Drezner, 2015). What is interesting, these measures were only once mentioned in the 2010 U.S. National Security strategy. In

contrast, the 2015 U.S. National Security strategy places a considerable emphasis on targeted sanctioning which is an effective tool for imposing costs on "irresponsible actors" and fighting criminal and terrorist groups.

Targeted financial sanctions as a cure-all for preventing violations

Targeted financial measures are superior to non-financial sanctions in two respects: first, as mentioned above, they impose significant costs on a target, second, this mechanism of sanctioning generates fewer incentives to violate restrictions, otherwise third parties, or so called "black knights", risk severe consequences (Drezner, 2015). Generally, financial sanctions presuppose that the proportion of costs and benefits for banks facilitating prohibited transactions changes. If caught, these mediators are likely to face costly penalties from the Department of the Treasury, in particular from the U.S. Office of Foreign Assets Control (OFAC). Even the threat of imposition and its anticipated effects can enforce compliance with international norms.

In any case, the U.S. financial hegemony is undisputed, and international financial actors need access for both U.S. dollars and the country's capital markets to conduct cross-border transactions. This access ensures abiding by the restrictions and in most cases outweighs potential benefits from violating provisions of OFAC economic sanctions programs. For example, in recent years the U.S. regulatory bodies fined major financial institutions, such as Credit Suisse, Barclays, Standard Chartered, BNP Paribas and others, up to $11 billion. In 2014, the Department of the Treasury settled the case with Fokker Services B.V., a Dutch aerospace service provider, over 1150 violations of U.S. sanctions on Sudan and Iran (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). The settlement cost the company $21 million. Not surprisingly, banks are concerned about a potential blow on their reputation and financial assets, which usually lowers sanctions-busting incentives.

In 2014, about $150 billion left Russia so that the businesses in private sector could avoid the prospect of targeted financial sanctions (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). The political pressure on Russia was intensified on

August 2, 2017, when Countering America‘s Adversaries through Sanctions Act came into law. According to section 241, The Secretary of the Treasury was to identify the most significant senior officials and oligarchs on the basis of their closeness to the ruling regime and involvement of major political entities in corruption (Timofeev, 2018). The so-called Kremlin Report can be considered from two perspectives. First, it necessitates maintaining a distance from the Russian government so as to avoid potential economic losses. Second, corrupt individuals identified in the report may be exposed to strict regulation beyond sanctions, such as FATF measures against financial malfeasance (Drezner, 2015).

The case of Iran is worth considering in particular. In 2010, the European Union and the United States imposed comprehensive sanctions on the Iranian financial sector. These restrictions were so tough that SWIFT immediately ended all transactions with Iranian banks blacklisted by financial watchdogs. The 2010 economic measures surpassed all initial assessments. By the end of 2013 Iran's president Hassan Rouhani made a public statement in which he admitted that the economic catastrophe justified negotiations on the Iranian nuclear program (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). His pre-election promises to address the nuclear issues greatly contributed to Rouhani's victory in the presidential election in 2013. However, it is also acknowledged that five decades of Iranian sanctions have not resulted in regime change. What is more, the economic coercion has even worsened Iran's conduct in the Middle East. For this reason, many analysists are highly skeptical that even "painful" targeted sanctions can produce a desired policy outcome.

Paradoxically, anemic growth in Russian and Iranian economies can be attributed to the slump in oil prices in 2014 and the failure of decisionmakers to correctly respond to the challenges in commodity markets. According to some scholars, analysists were likely to exaggerate the costs generated by sanctions versus other variables, as quantifying their deterrence presented a methodological problem. In this sense the case of Cuba is particularly instructive. Before the collapse of the

Soviet Union this country received annual subsidies of approximately $5 billion. In the early 1990s Cuba was cut off the essential financial aid. By 1993 merchandise imports fell by 75 percent, inflation rate and budget deficit increased to more than 200 and 30.4 percent respectively (Shiffman, 2002). The Cuban government introduced a series of reforms, among which was the Law on Foreign Investment. The positive investment climate created by the protection policies helped Fidel Castro to invite capitalists without the capitalism. However, the growing welfare of the middle class could trigger questioning the legitimacy of F. Castro, who rose to power through the Cuban revolution in 1959. The perceived threat caused him to retreat from some of the promising reforms and to subject civilians to repression. At the same period of time the U.S. adopted the Cuban Liberty and Democratic Solidarity Act of 1996 (LIBERTAD). This set of sanctions was believed to lead to the downturn of the Cuban economy (Shiffman, 2002). The empirical findings revealed that the reasons were beyond the external policy of the United States. First, Castro‘s political choices disincentivized foreign investors. It deprived the country of the essential money used to subsidize exports. Second, the sanctions were unilateral, and Cuba could trade with the rest of the world without negative consequences for its economic performance.

The overall efficiency of financial restrictions changes over time because targets get accustomed to all kind of external pressure (Drezner, 2015). Generally, prolonged interaction between senders and targets resembles the offense-defense paradigm in international security. Criminal non-state actors have adopted to FATF regulations on anti-money-laundering. It means that target key elites can also develop alternatives to sender capital markets. Indeed, ex post economic costs are often accounted for by mismanagement of target governments, as they underestimated potential risks caused by brand-new financial measures.

Sparing a target’s population from negative humanitarian outcomes

In most cases sanctions are aimed at punishing non-democracies where most people are excluded from any political developments. In fact, the economic

damage imposed on a target population does not translate into the political damage for a target regime. Sanctions are therefore supposed to result in political disintegration, as civilians do not want to suffer because of an internationally unpopular state policy (Lektzian, Souva, 2017). The mentioned facts underpinned a strong motivation for more precise targeting of individuals and companies associated with a target ruling regime.

Financial restrictions, particularly assets freezes, supposedly hurt a target elite as much as an innocent population, thus sparing the powerless (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). As opposed to targeted sanctions, comprehensive trade embargoes often led to a decline in the physical integrity of rights and consequently to massive human rights abuses. However, subsequent research into these particular forms of economic coercion showed that this category of restrictions generated even *greater* costs to human security, because the measures were designed to inflict *greater* economic pain (Drezner, 2015). The logic behind this correlation is that autocracy opts for escalation of violence against its population over rewarding the electorate in order to suppress growing dissatisfaction with the economic profile in a target country. In other words, it is a tactic for staying in power. The negative side effects of smart sanctions on a humanitarian situation proved to be even more crippling. In 2015, the UN High Commissioner for Human Rights appointed a Special Rapporteur on the negative impact of the unilateral coercive measures on the enjoyment of human rights. The main idea of the report by Idriss Jazairy consisted in urging the UN members to abandon sanctions as they failed to instigate policy changes in target countries [1].

Interestingly, economic restrictions often trigger a “rally-round-the flag” effect when authoritarian regimes manage to incorporate external economic pressure into their legitimation strategies. The relative efficiency of sanctions prove that autocracies remain extremely persistent under sanctions. It can be explained in the following way. Nowadays every state makes claims to its legitimacy, namely the

"righteousness" of political and social order, particularly when facing potentially dangerous economic crises (Grauvogel, Soest 2014). A political leader turns the criticism of his rule into the critique of a country's population and therefore brands a sender as an enemy and sanctions as the infringement of country's sovereignty. It is especially common among rigid societies. For example, the Middle Eastern monarchies often turn to Islam to avert the rise of radical opposition. Thus, a strong claim to legitimacy is an efficient tool used to enhance social cohesion by strengthening a common identity. The scope of interaction with a sender is also noteworthy. Limited societal, political and economic linkages make it easier to delegitimize sanctions and to justify a leader's right to rule (Grauvogel, Soest 2014). This helped the Castro regime to inflame anti-American sentiments.

The crisis of U.S. monetary hegemony

According to the International Monetary Fund, in 2019 the U.S. dollar made up over 60 % of all central banks foreign exchange reserves, which gives it the status of global currency. When interest rates change on Wall Street, capital markets respond. The U.S. controls most international transactions through SWIFT, whose members contact with each other more than 30 million times a day, and CHIPS processing $1.5 trillion-worth of payments on a daily basis [2]. If denied access to these systems, a financial institution suffers significant economic damage. Thus, the perceived efficiency of targeted financial sanctions depends on the de facto U.S. monopoly on global capital markets.

However, many political risk analysts warn that "weaponization of monetary policy" leads to abandoning the U.S. dollar amidst international financial adjustment. Switching out of dollars is the subject of widespread speculations (Drezner, 2015). For example, the potential rejection of the Iranian deal after congressional debates could question the dollar's status as the world's reserve currency (Rosenberg, Goldman, Drezner, Solomon-Strauss, 2016). This issue was acknowledged by both the Secretary of State and the Secretary of the Treasury.

Using dollars as political weapon triggers de-dollarization of assets and the search for new mechanisms of conducting cross-border transactions. Russia's President Vladimir Putin called on BRICS to develop a system of measures to prevent economic repression of countries which disagree with the U.S. and its allies on their foreign policy decisions. Some of Russian banks are used as expendable entities to protect major state-backed financial institutions, such as VTB and Sberbank. The dollar share of the country's foreign exchange reserves has fallen from 40 % to 24% as opposed to the same rate in 2013 [2]. Most of Russia's trade operations have shifted to rubles. China also follows the Russian Federation. Several years ago, it replaced SWIFT with its own payment systems. Paradoxically, even after the 2008 financial crisis the U.S. dollar still preserves the centrality to the global capital markets (Drezner, 2015). Though, if the Trump administration continues engaging in financial warfare, it might lead to the demise of America's financial supremacy in the long run.

Conclusions

The rise of targeted financial sanctions over the past several decades has been unquestionable. These measures are often the tool to which decisionmakers turn first to respond to a wide range of issues: from instigating democratization in authoritarian countries to struggling against international terrorism and the proliferation of weapons of mass destruction. However, the initial optimism about targeted financial restrictions expressed in academic circles has proved to be partly unjustified.

First, the effectiveness of targeted financial sanctions might wear off over time, as countries become aware of their significant costs and adjust to the "new normal". It is worth mentioning that in most cases innovation in the means by which international actors evade economic coercion follow the evolution of sanctions and their application.

Second, targeted financial sanctions were devised to hurt a ruling regime rather than to cause civilian suffering. Nonetheless, the empirical evidence reveals that

these measures come close to crippling comprehensive embargoes in their humanitarian and economic effects.

Third, the Trump administration has taken using targeted financial sanctions to a new level. Nowadays countries explore alternatives to the U.S. dollar trying to dethrone this mighty currency. However, during the Great Recession the U.S. even strengthened its financial supremacy. The U.S. still has a tight grip on most cross-border transactions, because no other capital market can be compared to the dollar's liquidity and depth so far.

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