



Coercive Diplomacy

Evaluating the Consequences of Financial Sanctions

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Coercive Diplomacy and the New Financial Levers

Evaluating the Intended and
Unintended Consequences of
Financial Sanctions

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INTRODUCTION

One of the most promising emerging levers of coercive statecraft is the 'reputational' financial sanction. These sanctions, recently employed by the United States against Iranian and North Korean banks, aim to chill investment into these countries by threatening the financial reputations of legitimate institutions in an interconnected world. They have received considerable press attention and policymakers have heralded them as the key to "smart sanctions" – discriminating and effective. Yet much about these sanctions remains only dimly understood, including the causal mechanisms by which they operate; how effective they are; and whether they have blowback effects. This paper addresses these issues, setting 'reputational' financial sanctions in the context of the traditional literature on coercion theory and economic sanctions. The goal is to better understand these tools so they may be most effectively employed in economic statecraft.

Since 2005, the United States has targeted the Iranian and North Korean financing of illicit activities by publicly sanctioning state banks caught supporting terrorism and proliferation. The goal of this public action is to chill investment by legitimate third parties; for legitimate financial institutions, doing business with banks tainted by association with illicit activities threatens their reputation in the international banking community. To preserve their reputational brand, these banks reduce their investments and dealings with the institutions engaged in illegal behavior. In turn, this reduces the ability of these illicit banks to finance illegal activities and may induce their sponsoring-states to change their behavior. Anecdotal information suggests this tactic has been effective; recent U.S. sanctions on Bank Sepah, Bank Saderat and Bank Mellat in Iran led European banks to significantly curtail their business ties.

The new sanctions seem to promise a new and highly useful form of coercive leverage. Yet several questions about their operation warrant further exploration. First, what are the mechanisms by which they operate? Do legitimate institutions refrain from involvement because of the stigma introduced by the original designation or out of fear that the U.S. action is the first in a series of escalating designations which might catch their own business? Second, how efficient are these sanctions? Compared to traditional sanctions, how difficult was it for the United States to get the sanctions in place? And how difficult was it to get the sanctions to bite? Do these allow for highly leveraged action by the United States? What percentage of the sanctions impact hits the intended targets?

Third, how effective are these sanctions? What is the magnitude and nature of this effect? In the Iranian and North Korean cases, did they influence state behavior? Did this reduction in investment affect the capability of these countries to continue supporting illicit activities? Fourth, what are the negative consequences of employing these sanctions? Comprehensive sanctions often hurt innocents even as they put pressure on the regime. What are the expected but unintended results of reputational sanctions? For example, once a sanction affecting a bank's reputation is enacted, it cannot be switched off quickly; unlike an embargo, which can be easily lifted, reputational damage may be 'sticky,' and negatively affect banks long after they have ceased business relations with transgressing institutions. Such 'stickiness' may make these sanctions more effective in the short run, but counterproductive in the long run because they undermine attempts to unwind the coercive bargaining. They may even make these sanctions a harder political sell; allies and friendly countries may be more reticent to employ mechanisms that could threaten the long-term health of their financial institutions. Understanding the drawbacks of these tools is essential in determining when they should, and should not, be used.

This paper addresses these four broad questions in three steps. First, it reviews the academic literature studying diplomatic coercion, economic sanctions and the operation of reputations in international relations, and then situates these new sanctions within that literature. Second, drawing on not for attribution elite interviews with senior U.S. administration officials and other the primary accounts, it provides a brief case history of these sanctions and an in-depth examination of the causal mechanisms by which they work. Third, it analyses the effectiveness of these sanctions, their primary shortcomings, and how their advantages and disadvantages compare to other types of sanctions.

CHAPTER I

LITERATURE REVIEW

Coercive Diplomacy and Economic Sanctions

Economic sanctions are a tool – a particularly important if controversial tool – of coercive diplomacy. Coercive diplomacy refers to any efforts by one international actor to get another international actor to act in a way that the second international actor would not otherwise choose to act (e.g. surrender territory or make a concession in international bargaining or abandon the pursuit of WMD). It runs the gamut from hectoring, as in the diplomat's favored tool of a sternly worded demarche all the way to military operations, including invasion. Most of coercive diplomacy involves pressure short of the use of force and the use of economic sanctions looms especially large in the history of coercion, dating all the way back to ancient times. For example, when Athens imposed a trade boycott on Sparta's ally Megara in 432 BCE, they were imposing economic sanctions in the service of coercive diplomacy (hastening the onset of the Peloponnesian War in the process) and in doing so they confronted challenges that would be familiar to any government leader since.¹ Yet while policymakers have often found economic sanctions to be a favored tool of statecraft, academic experts have vigorously debated the utility of this form of coercion. Therefore, the new economic sanctions under study here are thus but the latest innovation in a well-established field of practice and study. Just how evolutionary or revolutionary an innovation depends upon whether the new sanctions challenge basic tenets of coercion theory or overcome the traditional limitations plaguing coercive diplomacy.

In the international relations literature, coercive diplomacy, at its core, has two characteristics: first, it is meant to change the target's behavior; and second, it does so by

¹ Thucydides, *History of the Peloponnesian War*, Trans Richard Crawley, (New York: Modern Library, 1951), pp.78-83.

threatening pain (including, but not necessarily the use of force) in limited amounts.² In contrast to what Thomas Schelling describes as brute force, the purpose of coercion is not to eradicate the adversary, but rather cause him to adjust.³ According to Schelling, the key to its successful use is the threat of more punishment; by imposing pain only in limited amounts, the coercer signals that he is willing and able to ratchet up the punishment, hence providing an incentive for the target to acquiesce to his demands. Coercion thus takes the form of a mathematical formula, calculating the increment of pain needed to break the will of the target to resist. Coercion became a major focus of study during the early years of post-World War II strategic studies, with economists at RAND doing some of the most important pioneering work. Daniel Ellsberg, later of Pentagon Papers fame, presented the seminal theoretical work in "Theory and Practice of Blackmail."⁴ He identified a simple formula that specified the "critical risk," the point at which if you thought the probability of punishment was greater you would comply and if you thought probability of punishment was less you would not comply.⁵

What worked in theory proved difficult to implement in practice, however. As the coercive bombing attempts by the United States against North Vietnam in the 1960s and 70s illustrated, coercion was far more intricate and double-edged than merely the mechanistic application of increasing punishment to cause a change in target state behavior. Part of the problem may have been the difficulty in determining the "critical risk" point of a real live adversary. But the Vietnam experience also suggested a more fundamental flaw in early coercion theory. The graduated and calibrated steps of Ellsberg's elegant blackmail likely conveyed mixed signals to the adversary. One signal was the intended message: the United States wanted the North Vietnamese to know that we were committed and that we intended to increase the pain unless the North Vietnamese met our demands. But another likely signal was an opposite message: the United States was not that resolved or we would have inflicted far more pain – we would have bombed more targets, sent larger numbers of ground troops, imposed a more draconian naval blockade, and so on. In this way, counter-intuitively, the use of finely tailored coercive diplomacy can actually signal irresolution on the part of the coercer.

2 Robert Art, "The United States and Coercive Diplomacy: What Do We Know?" in Robert Art and Patrick Cronin eds., *The United States and Coercive Diplomacy* (Washington D.C.: United States Institute of Peace, 2003). The academic literature on coercion theory is vast and spans many decades. The classic texts in the canon include: Thomas Schelling, *Arms and Influence* (New Haven: Yale University Press, 1966), Thomas Schelling, *The Strategy of Conflict* (Cambridge: Harvard University Press, 1981), Daniel Ellsberg, "The Theory and Practice of Blackmail," P-3883, RAND Corporation, July 1968, Alexander George, *Forceful Persuasion: Coercive Diplomacy as an Alternative to War* (Washington D.C.: United States Institute of Peace, 1991), Alexander George and Richard Smoke, *Deterrence in American Foreign Policy* (New York: Columbia University Press, 1974), Richard Betts, *Nuclear Blackmail and Nuclear Balance* (Washington D.C.: Brookings Institute Press, 1987), Glenn Snyder and Paul Diesing, *Conflict Among Nations* (Princeton: Princeton University Press, 1978). More recent works that have made an important contribution to the theory and the analysis of the empirical record include: Kenneth Schultz, *Democracy and Coercive Diplomacy* (Cambridge: Cambridge University Press, 2001) and Daniel Byman and Matthew Waxman, *Dynamics of Coercion* (Cambridge: Cambridge University Press, 2002). For a bibliography of coercion studies, see http://www.rand.org/pubs/monograph_reports/MRI494/MRI494.bib.pdf

3 Schelling (1966), p.3.

4 Ellsberg (1968).

5 Ellsberg couched his formula in terms of actual and critical risk: if your actual risk (subjective probability of punishment multiplied by the cost of punishment) was higher than your critical risk (the maximum amount of pain, defined as the probability of punishment multiplied by the cost of punishment, you would be willing to endure), you would concede. Ellsberg (1968), p.10. In later work, Robert Pape adapted this logic thus: the target state will concede when $R < Bp(B) - Cp(C)$, where the value of resistance (R) is less than the potential benefits of resistance (B) times the probability of attaining benefits p(B) by continued resistance minus the potential costs of resistance (C) times the probability of suffering costs p(C). Robert Pape, *Bombing To Win* (Cornell: Cornell University Press, 1996). For an extensive critique of this formulation and the way in which Pape applies it, see Barry Watts, "Ignoring Reality: Problems of Theory and Evidence in Security Studies," *Security Studies* Vol.7, No.2 (1997), pp.129-149.

The gradual ramping up of pressure may further have produced two contrary results that unintentionally reduced North Vietnamese incentives to capitulate. First, the actual imposition of pain may have raised the stakes of the contest for the North Vietnamese, adding a measure of “face” that further complicated the diplomacy. A concession that the North Vietnamese might have been willing to make in a voluntary diplomatic bargain could have become more distasteful if elicited through coercion, causing North Vietnam to lose face for backing down under pressure. Second, the slowness of the imposition of pain may have given the North Vietnamese time to adjust psychologically and otherwise, thus undermining the coercive effect.⁶

Subsequent research in coercive diplomacy thus focused more closely on the interactive process between the target and the sender that the Vietnam failure illuminated.⁷ In particular, scholars focused on three main pivot points that drive success or failure in coercion: (1) the demands or stakes involved in the dispute; (2) the clarity and perception of the signal communicated by the coercion effort; and (3) the pain tolerance and mitigation strategies available to the participants.

Stakes are an obvious factor affecting success. If the goal sought is prized too highly by the target to be surrendered for the amount of pain the coercer is willing or able to inflict, then the coercion attempt will fail. Since the targets of coercion are the decisionmakers of foreign

Coercive diplomacy is a competition in mutual pain that continues until one of the parties cries uncle

regimes and since those decisionmakers probably value most of all their hold on power, the most extreme goal would be regime change and it would require the most extreme coercion. But even lesser goals can, in the perception of the targets, be valued so highly that they are tantamount to regime change. In the North Korean case, for example, many policymakers and scholars argue that their nuclear weapons program is too valuable as a deterrent to give up, regardless of the degree of punishment leveled by the international community, because the regime is basing its own survival on the possession of those nuclear weapons.⁸

Ascertaining what is at stake – or more precisely, how each party in the dispute values what is at stake – is very difficult because the parties have an incentive to misrepresent their true views in the hopes of getting a better deal in the contest.⁹ And once the threat is made, the balance of resolve can change because both the sender and the target have newfound incentives to achieve their goals and not be seen as caving to pressure. James Fearon and Michael Tomz have shown theoretically and empirically that backing down as a

6 Pape (1996), chapter 5.

7 Daniel Byman and Matthew Waxman, “Kosovo and the Great Airpower Debate,” *International Security* Vol.24, No.4 (2000), pp.9-11.

8 For a discussion of these issues, see Jonathan Pollack, “North Korea’s Nuclear Weapons Development,” *Proliferation Papers*, No.33, Spring 2010. Available at: <http://ifri.org/downloads/pp33pollack.pdf>

9 On cheap talk in international politics, see Andrew Kydd, “Which Side Are You On?: Bias, Credibility and Mediation,” *American Journal of Political Science* Vol. 47, No.4 (2003), pp.597-611. See also Anne Sartori, *Deterrence By Diplomacy* (Princeton: Princeton University Press, 2005).

result of a coercive threat can have significant domestic political consequences in the form of audience costs.¹⁰ Effective coercion, then, may require giving the target a face-saving way of capitulating and not backing them into the corner.¹¹

The clarity of the threat also affects the success of coercive diplomacy, but in contradictory ways. On the one hand, ambiguity provides wiggle room to overcome the face-saving constraint and the uncertainty can even enhance the power of inherently incredible threats such as the threat to use nuclear weapons – what Schelling called “the threat that leaves something to chance.”¹² On the other hand, a coercive threat that is vaguely delivered and subject to multiple interpretations might be misunderstood by the target, leading to coercion failure. Schelling explained this insight best, too:

Recall the trouble we had persuading Mossadegh in the early 1950s that he might do his country irreparable damage if he did not become more reasonable with respect to his country and the Anglo-Iranian Oil Company. Threats did not get through to him very well. He wore pajamas, and, according to reports, he wept. And when British or American diplomats tried to explain what would happen to his country if he continued to be obstinate, and why the West would not bail him out of his difficulties, it was apparently uncertain whether he even comprehended what was being said to him. It must have been a little like trying to persuade a new puppy that you will beat him to death if he wets on the floor. If he cannot hear you, or cannot understand you, or cannot control himself, the threat cannot work and you very likely will not even make it.¹³

Finally, pain tolerance also is critical. Coercive diplomacy is a competition in mutual pain that continues until one of the parties cries uncle. This suggests that the larger powers, because they have more power at their disposal, should be able to bring more pain to bear on smaller targets and therefore coerce them successfully. This happens often enough to be a reasonable rule of thumb, but the exceptions are significant and, in fact, quite numerous and can be understood systematically. First is the relative importance of the issue at stake. The smaller state may have more at stake or value the issue more than the stronger state; as many argued was the case in the Vietnam war.¹⁴ Second, though a state might be larger; that does not necessarily mean it can bring more pain to bear on a target. Perhaps, through asymmetric means such as terrorism, a smaller state can “punch above its weight,” inflicting greater-than-expected pain on the larger state. Third, and most interestingly, scholarship by David Baldwin suggests that the larger state may be systematically *disadvantaged* in such competitions of mutual pain. Because

¹⁰ On this bargaining point, see James Fearon, “Domestic Political Audiences and Escalation of International Disputes,” *American Political Science Review* Vol.88, No.3 (1994). On empirical testing, see Michael Tomz, “Domestic Audience Costs in International Relations: An Experimental Approach,” *International Organization* Vol.61, (2007), pp.821-840.

¹¹ Schelling (1966), pp.43-51. Schelling argues that the face-saving constraint varies depending on the kind of threat involved. Deterrent threats – “do not attack us or we will retaliate” – do not pose such a severe constraint; targets of deterrent threats can concede without conceding publicly, claiming merely that they never intended to attack in the first place. By contrast, a coercive threat that requires a change in the status quo ante – what Schelling called a “compellent threat” – involves the face saving constraint to a greater degree.

¹² Schelling (1981), chpt.8.

¹³ Schelling (1966), p.38.

¹⁴ On this point, see Andrew Mack, “Why Big Nations Lose Small Wars: the Politics of Asymmetric Conflict,” *World Politics* Vol.27, No.2 (1975), pp.175-200. On a critique of this theory, see Ivan Arreguin-Toft, “How the Weak Win Wars: A Theory of Asymmetric Conflict,” *International Security* Vol.26, No.1 (2001), pp.93-128.

the state is larger; the consequences of losing the issue at stake are often, *ceteris paribus*, less significant, and therefore the larger state will not fight as hard for the issue. Thus, smaller states may actually have an advantage in these bargaining-by-violence circumstances.

Pain tolerance is a function both of the inherent “toughness” of the combatants and of the capability of the combatants to mitigate the pain somehow.¹⁵ In a seminal study on the changing nature of power, Robert Keohane and Joseph Nye distinguished between *sensitivity interdependence* and *vulnerability interdependence*.¹⁶ *Sensitivity* referred to the speed and magnitude with which a change in one part of a system spread to another part – in the case of coercive diplomacy, the speed and magnitude by which an imposition of

The imposition of economic sanctions imposes economic pain on the target, but also on the sender

pain was felt by the target. *Vulnerability* referred to the extent of options available to the target to reduce the pain – in the case of coercive diplomacy, the ability of the target to shift the pain from less tolerable forms to more tolerable forms. For example, throughout the sanctions regime imposed on Iraq in the 1990s and early 2000s, Saddam was able to divert the pain away from the sectors of Iraqi society and the Iraqi state he valued most highly – his regime supporters and his Republican Guard – and on to the rest of the Iraqi public, about which he cared considerably less. Indeed, on the margins, the efforts to coerce Iraq may even have strengthened Hussein vis-à-vis his internal competitors because the external pressure provided him with a ready excuse for all his governing failures and he was able to divert the pain from sanctions onto rivals.

Note that the pain tolerance of both actors is relevant. Any effort at coercion imposes pain on the target and on the sender. The pain on the target may be more severe, but the pain experienced by the sender may be more consequential for the success of the coercion. In the case of the Vietnam War, there is no question that the North Vietnamese suffered more pain in absolute terms than did the United States. And yet, the pain endured by the United States proved more “painful,” that is the United States gave up before the North Vietnamese did.

All of these reasons contribute to what political scientists call the “selection effect” inherent in coercive diplomacy: the fact that escalating coercive pressure is inherently less likely to succeed than the balance of power and resolve might predict (at least the balances that are perceivable in advance). If the escalatory pressure was highly likely to work (to be sufficient to cause capitulation), then the threat of escalating should have worked as well and the target should have conceded already. The only cases that are likely to show up in the real world are those where prior threats proved inadequate, presumably because the balance of power or resolve was not in fact what some thought it would be.¹⁷ The only wars we should see are ones where the deterrent threat of force was inadequate; the only threats of force we should see are ones where lesser diplomacy had failed; and so on. This does not mean that coercion will always fail, just that coercion by necessity involves the “hard cases,” not the easy ones.

¹⁵ Byman and Waxman (2000), pp. 9-11.

¹⁶ Robert Keohane and Joseph Nye, *Power and Interdependence* (Boston: Little Brown and Company, 1977).

¹⁷ For more on selection effects and coercion, see James Fearon, “Signaling versus the Balance of Power and Interests: An Empirical Test of a Crisis Bargaining Model,” *Journal of Conflict Resolution* Vol.38, (June, 1994), pp.236-69. Daniel Drezner, “The Hidden Hand of Economic Coercion,” *International Organization* Vol.57, No.3 (2003), pp.643-659.

One further basic insight from coercion theory warrants mention: coercion involves the simultaneous promise of both punishment and reward. The punishment is the imposition of pain; the reward is the promised lifting of that pain if the target makes the desired concession. In the informal language of carrots and sticks, every stick implies a carrot. To reinforce this aspect of coercion, senders can augment the promise with additional incentives – carrots beyond the promised abandonment of the pain-inducement.¹⁸ But the most important carrot is the implied promise to relax the imposition of pain – to stop beating the target with the stick – once the target concedes. Coercers must be credible on both sides: the threat to impose the pain must be credible and the promise to lift the pain must be credible. If the sender asserts that, in exchange for the target performing X, it will stop imposing punishment Y, yet when the target performs X, no change in Y occurs, the target state has a great incentive to revert back to its original defiant stance.

All of the foregoing applies regardless of the type of coercion imposed, whether a sternly worded demarche or a sustained aerial bombardment. In the special case of economic coercion – the imposition of economic sanctions – the challenges of coercion are even more acute.

Economic Sanctions: An Increasingly Popular Tool of Coercion

Economic sanctions transmit pain onto a target – in this case, hitting the target where it especially hurts, the pocketbook – in an effort to change the target's behavior. Practitioners have seen fit to resort to economic sanctions with increasing frequency over the last several decades. In the process, practitioners have refined the tool – the “new financial levers” under study here serving as the current state of the art. Yet economic sanctions have particular strengths and weaknesses as coercive tools and the scholarship on sanctions is marked by deep skepticism about their utility.¹⁹

The most obvious and yet perhaps the most profound characteristic of economic sanctions is that they constitute a double-edged sword. The imposition of economic sanctions imposes economic pain on the target, but also on the sender. The target is denied a certain amount of commerce, but that commerce is also denied to the sender. In this way, economic sanctions are vivid contests in pain. Will the pain caused by foregone economic benefits hurt the target faster and more deeply than it hurts those who must impose the sanction? For each side, the pain is linked to behavior: for the target, the pain is linked to the offending behavior; and for the sender the pain is linked to the behavior

18 Richard Haass and Meghan O'Sullivan, *Honey and Vinegar: Incentives, Sanctions and Foreign Policy* (Washington, D.C.: Brookings Institution Press, 2000). For a critique of the effectiveness of inducements, see Daniel Drezner, “The Trouble with Carrots: Transaction Costs, Conflict Expectations, and Economic Inducements,” *Security Studies* Vol.9 (Autumn 1999/Winter 2000), pp.188-218.

19 For a sampling of such work, see Gary Hufbauer, Jeffrey Schott and Kimberly Anne Elliot, *Economics Sanctions Reconsidered* (Washington, D.C.: Institute for International Economics, 1985). Elizabeth Rogers, “Using Economic Sanctions to Control Regional Conflicts,” *Security Studies* Vol.5, No.4 (1996). Barry Carter, *International Economic Sanctions: Improving the Haphazard U.S. legal Regime* (New York: Cambridge University Press, 1998). One of the most recent examples of this cross-fertilization is research conducted and presented by the Watson Institute for International Studies at Brown University. For a description of the academic research and how scholars have presented it to policymakers, see Thomas Biersteker and Sue Eckert, *Strengthening Targeted Sanctions Through Fair and Clear Procedures* (Providence: Watson Institute for International Studies, 2006). For coordination efforts with federal and international governmental bodies on sanction implementation, see summaries of conferences and congressional testimony: http://www.watsoninstitute.org/project_detail.cfm?id=4#pubs. Accessed 4 April 2009.

of imposing the sanction. The political contest is thus: will the target change his behavior before the sender changes his behavior?

Viewed this way, in every case of economic sanctions, the coercion is successful. Sometimes the sender's coercion of the target works in that the target capitulates. Sometimes the target's coercion of the sender (in the form of defiantly prolonging the pain contest) works in that the sender backs off. While this perspective yields interesting insights (as we discuss below in the relative susceptibility of democratic vs. authoritarian regimes to economic coercion), the more conventional understanding in the academic literature and in practice is to measure the effectiveness of sanctions only with respect to the target's behavior.

Thus, Robert Pape defines economic sanctions as working if, "(1) the target state conceded to a significant part of the coercer's demands; (2) economic sanctions were threatened or actually applied before the target changed its behavior; and (3) no more-credible explanation exists for the target's change of behavior."²⁰ By these criteria and by his coding, economic sanctions worked in only five times out of a universe of one hundred and fifteen cases. This assessment was considerably bleaker than the more bullish assessment of Hufbauer, Schott and Elliot who determined forty of one hundred and fifteen cases²¹ were instances of sanction success.²² While some of the discrepancy is due to arguments about the details of specific cases, most of it comes from Pape's stringent application of each criterion, especially the last.²³ Yet this third criterion is problematic because when multiple coercive tools are used (economic sanctions plus threats of force plus diplomatic isolation), Pape tends to credit the other tools as "more-credible." The expectation that sanctions work in isolation is artificial and impossible to sustain in the real world;²⁴ sanctions are almost never used in isolation from other tools of coercive power (and indeed the issuance of sanctions can implicitly suggest the threat of the use of force if the sanctions are unsuccessful).²⁵

Moreover, as Daniel Drezner and Irfan Nooruddin have argued, restricting the universe of cases examined to those where sanctions have been formally applied could significantly understate the utility of sanctions because of potentially powerful selection effects.²⁶ As noted earlier, the actual imposition of sanctions only arises when the threat of sanctions – or perhaps even just the anticipation of their use – was insufficient to change the behavior of the target. That is, sanctions are only applied to states that showed a high enough determination to resist outside pressure in the form of a threat to impose sanctions. There may be many cases where states backed down or otherwise conceded a point because they anticipated that if they did not, they would suffer sanctions and the issue was not worth that much pain. If there are many such cases, then sanctions may be more powerful than existing academic studies have concluded. One intriguing study suggests this might be the case, as Marc Busch and Eric Reinhardt argue

20 Robert Pape, "Why Economic Sanctions Do Not Work," *International Security* Vol.22, No.2 (1997), p.97.

21 *Ibid.*, p.93.

22 For another critique of Hufbauer, Schott and Elliot's research, see Cooper Drury, "Revisiting Economic Sanctions Reconsidered," *Journal of Peace Research* Vol.35, No.4, pp.497-509. For a recent empirical assessment that more closely aligns with Hufbauer, Schott and Elliot, see Clifton Morgan, Navin Bapat, and Valentin Krustev, "The Threat and Imposition of Economic Sanctions, 1971-2000," *Conflict Management and Peace Science* Vol.26, No.1 (2009), pp.92-110.

23 Pape (1997), p.92.

24 *Ibid.*, p.93. For a good critique of this general line of argument, see Byman and Waxman (2000).

25 Kimberly Anne Elliot, "The Sanctions Glass: Half Full or Completely Empty?" *International Security* Vol.23, No.1 (1998), pp.54-55.

26 Drezner's version of this insight yields an additional counter-intuitive hypothesis: that sanctions will work better on friends than on enemies. Daniel Drezner, *The Sanctions Paradox* (Cambridge: Cambridge University Press, 1999). Irfan Nooruddin, "Modeling Selection Bias in Studies of Sanctions Efficacy," *International Interactions* Vol.28, No.1 (2002), pp.59-75.

that in GATT and WTO economic disputes, states considering violating anti-protectionist measures will abstain because of uncertainty about possible retaliation from other countries.²⁷

Nevertheless, there is consensus in the field that sanctions are highly unlikely to achieve ambitious foreign policy goals.²⁸ Goals like regime change and other steps that are tantamount to capitulation by the target are beyond the reach of most economic sanctions – and, for that matter, beyond the reach of most coercive diplomacy short of full invasion. Beyond this broad point, the academic literature is unsatisfying, as it tends to treat sanctions in ways that are removed from the actual context surrounding their implementation and how policymakers view them. For example, scholars tend to dichotomize sanction outcomes into clear cases of success and failure based on whether the coercive actions changed the target state behavior. While this is one purpose of sanctions, as James Lindsey and Francesco Giumelli have noted, sanctions can be used by sender states to achieve a broader variety of objectives, such as: third party signaling, where sanctions are imposed as a threat to other states not to engage in the same behavior; domestic political reasons because doing nothing might not be a sufficient response for the public; bolstering international support for follow on actions, as contemporary policymakers assert that enacting sanctions is often important in showing that no other option short of force will be successful in coercing the target state and that, if states are serious about preventing the proscribed behavior, force may be the only possibly successful policy; or simply for capability degradation, changing a target state's behavior by denying it access to goods that would allow it to engage in a particular set of actions as the United States did throughout the Cold War vis a vis the Soviets with the Coordinating Committee (CoCom).²⁹ Indeed, as Jonathan Kirshner remarks,

The most obvious and yet perhaps the most profound characteristic of economic sanctions is that they constitute a double-edged sword

The full range of goals refers to the fact that a state may initiate sanctions not simply to compel action on the part of the target, but to communicate its preferences, support allies, deter others from engaging in similar activity, and dissuade the target from expanding its objectionable activity. Sanctions may also be designed to punish, weaken, distract, or contain the adversary. Thus sanctions may fail to move the target, but may be successful along a number of other dimensions, complement other policies, and remain an appropriate policy instrument.³⁰

27 Marc Busch and Eric Reinhardt, "Bargaining in the Shadow of the Law: Early Settlement in GATT/WTO Disputes." *Fordham International Law Journal* Vol.24, No.1 (2001), pp.158-172.

28 Elliot (1998), pp.50-1. Clifton Morgan and Valerie Schwabach, "Fools Suffer Gladly: The Use of Economic Sanctions in International Crises," *International Studies Quarterly* Vol. 41 (1997), pp. 27-50. Adrian U-Jin Ang and Dursun Peksen, "When Do Economic Sanctions Work? Asymmetric Perceptions, Issue Salience, and Outcomes." *Political Research Quarterly* Vol.60, No.1 (2007), pp.135-145.

29 Lindsey argues that policymakers use sanctions to achieve compliance (effectively a change in the target state's behavior), subversion (removal of the leaders of a regime), deterrence (dissuading the target from repeating an action), international symbolism (signaling third parties that similar action will be met with imposed costs), and domestic symbolism (increasing domestic support or thwarting criticism). James Lindsey, "Trade Sanctions as Policy Instruments: A Re-Examination," *International Studies Quarterly* Vol.30, No.2 (1986), pp.155-156. See also Francesco Giumelli (2009), "Measuring the Success of Sanctions," Paper presented to the American Political Science Association's Annual Meeting, 4 September 2009. Toronto, Canada. For more on basic capability degradation, see Michael Mastanduno, *Economic Containment: CoCom and the Politics of East-West Trade* (Ithaca: Cornell University Press, 1992).

30 Jonathan Kirshner, "The Microfoundations of Economic Sanctions," *Security Studies* Vol.6, No.3 (1997), p.34. See also Jonathan Kirshner, *Currency and Coercion: The Political Economy of International Monetary Power* (Princeton: Princeton University Press, 1997).

In fact, under the just war tradition, sanctions may even be a necessary prelude to force. It must be shown that force is the last resort – that other steps short of military force were tried and found wanting – before the horrors of war can be deemed a necessary evil. In cases where military force is needed, policymakers may apply economic sanctions not expecting them to work, but expecting to demonstrate thereby that all plausible alternatives were attempted. A scholar's database might deem these sanctions as "not effective" and at some level that may be true, and yet the resort to even ineffective sanctions may be wise statecraft.³¹

David Baldwin suggests a more sophisticated metric for judging the effectiveness of sanctions in his book *Economic Statecraft*.³² Instead of examining only whether the target acquiesced to the demands of the coercer, Baldwin argues that the costs of the chosen policy should also play a role in deciding a course of action.³³ In effect, Baldwin suggests

These targeted sanctions, including travel bans and financial freezes, have become significantly more prevalent as a policymaking tool since the late 1990s, and prominent examples include sanctions on the former Yugoslavia, Iraq, and Iran

that in selecting tools of statecraft leaders make cost-benefit assessments of each tool; in these assessments, probability of effectiveness is an important – but not the only – criterion that needs to be weighed.³⁴ For example, as Baldwin notes, it might be the case that military force will more likely result in a successful coercive attempt but that, vis a vis economic sanctions, the costs are prohibitively high. In such a circumstance, the utility of imposing sanctions is greater than the alternative.³⁵ Indeed, such a comparison is crucial because every policy adopted has opportunity costs.³⁶ Baldwin thus captures well the policymaker's predicament: surveying his toolbox, the policymaker is acutely aware that every tool – including the tool of "kicking the can down the road" – has a drawback. The tool chosen is not necessarily the one that has the best chance of working. It may be the tool that offers a plausible chance of working and that costs less to implement than the alternatives.

There is a premium, then, in understanding the relative costs and benefits of different types of sanctions. The most general categorization scheme distinguishes between two broad categories: comprehensive and targeted ('smart') sanctions, with each having different operating mechanisms and probabilities of success under different circumstances.³⁷ On the one hand, comprehensive sanctions are designed to affect broad swaths of the population, usually by limiting trade with the target country. In the application of such sanctions, the coercer does not differentiate between entities and organizations within

31 On policymakers continuing to use sanctions despite the low likelihood that they will succeed in a traditional sense, see Daniel Drezner, "Sanction Sometimes Smart: Targeted Sanctions in Theory and Practice," *International Studies Quarterly*, Forthcoming (2010), p.7.

32 David Baldwin, *Economic Statecraft* (Princeton: Princeton University Press, 1985).

33 Baldwin defines costs as, "values forgone as a result of the decision." David Baldwin and Robert Pape, "Evaluating Economic Sanctions," *International Security* Vol.23, No.2 (1998), p.128. Indeed, Baldwin directly attacks Pape's conceptualization of effectiveness in two articles appearing at the same time as the Elliot/Pape debate. See David Baldwin, "The Sanctions Debate and The Logic of Choice," *International Security*, Vol.24, No.3, (1999-2000), pp.80-107.

34 Baldwin (1985), p.119.

35 *Ibid*, pp.121-3.

36 Baldwin's discussion is problematic in a variety of ways however. He claims that, "Increased costs are political effects. Not all influence is manifest in terms of changes in policy; changes in the costs of noncompliance also constitute influence." Baldwin (1985), p.133. By asserting that economic statecraft is having an influence even when one cannot see the effects makes it impossible to disprove and therefore poor social science.

37 For a more detailed discussion of the different forms of sanctions, see Kirshner (1997), pp.36-41.

the target state, but rather applies the sanctions universally to the country. Well-known examples of such sanctions include U.S. trade embargoes on Iran and oil sanctions on Iraq in the 1990s and early 2000s.³⁸

On the other hand, and stemming from many of the negative experiences with such sanctions in the 1990s, targeted sanctions focus on particular entities of the political, social and economic elite in the target country.³⁹ These targeted sanctions, including travel bans and financial freezes, have become significantly more prevalent as a policymaking tool since the late 1990s, and prominent examples include sanctions on the former Yugoslavia, Iraq, and Iran.⁴⁰ Sanctions can be targeted along two different but mutually reinforcing dimensions. First, sanctions can be targeted on specific items of particular value. Second, sanctions can be targeted on specific individuals or entities that have particular sway over the target country's behavior; political scientists call this group the "selectorate," the relevant group that picks and empowers key political leaders.⁴¹ Ideally, targeted sanctions would impose pain on items of special value to the selectorate rather than imposing pain generally on the target society – for instance, seizing the secret bank accounts of the leader and his family rather than restricting the access of all citizens to basic foodstuffs.⁴²

There is an emerging consensus in the literature that targeted sanctions are more effective at changing target state behavior in autocratic regimes whereas comprehensive sanctions are more effective in democratic ones.⁴³ The logic behind this assessment rests on the supposed causal mechanisms by which the sanctions operate. Comprehensive sanctions, because they are undifferentiated, target large swaths of the population. Returning to the transmission analogy above, this increased pain to the general population is supposed to cause discontent and subsequent pressure on elites by the citizenry. If the elites depend on the general population for their power, they will be responsive to this pressure; this is more likely to be the case in democratic regimes.⁴⁴ Interestingly, research suggests that sanctions targeting democracies are more likely to result in a change in target state behavior.⁴⁵

38 Drezner (2010), pp.4-7.

39 For a recent assessment of these types of sanctions, see Drezner (2010), pp.8-11.

40 Biersteker and Eckert (2006).

41 Bruce Bueno de Mesquita, Alastair Smith, Randolph Siverson and James Morrow, *The Logic of Political Survival* (Cambridge: MIT Press, 2004).

42 For an assessment of whether these sanctions may reduce negative humanitarian effects on the civilian population, see Drezner (2010), pp.11-12.

43 Risa Brooks, "Sanctions and Regime Type: What Works, and When?" *Security Studies* Vol.11, No.4 (2002), pp.1-50. See also Sean Bolks and Dina Al-Sowayel, "How Long Do Economic Sanctions Last? Examining the Sanctions Process Through Duration," *Political Research Quarterly* Vol.53, No.4 (June 2000), pp.241-265. Susan Allen, "The Determinants of Economic Sanctions Success and Failure," *International Interactions* Vol.31, No.4 (2005), pp.117-38.

44 Kirshner (1997), pp.41-50. See also Jean Marc Blanchard and Norrin Ripsman, "Asking the Right Question: When Do Economic Sanctions Work Best?" *Security Studies* Vol.9, No.1 (1999), pp.219-253.

45 David Lektzian and Mark Souva, "An Institutional Theory of Sanctions Onset and Success," *Journal of Conflict Resolution* Vol.51 (2007). The databases may understate the effectiveness of sanctions on democracies, because they do not count as "working" those cases where democracies abandoned the sanctions (unilateral or multilateral). In the contest of pain with a double-edged sword, it may be that democracies are more prone to cry uncle (to abandon the sanction short of achieving the desired goal) than are their targets. Arguably, this is precisely what happened in the case of Western efforts to sanction the Chinese regime for human rights violations after Tiananmen. The sanctions "worked," but for the Chinese not for the Western powers because the economic pain convinced the West to downgrade their human rights demands. For more on the record of economic sanctions in the Chinese human rights case, see A. Cooper Drury and Yitan Li, "U.S. Economic Sanction Threats Against China: Failing to Leverage Better Human Rights," *Foreign Policy Analysis*, Vol.2, No.4 (2006), pp.307-324.

In contrast, autocratic regimes rely only on a small subset of the population to remain in power – they have a smaller electorate – and given this authoritarian control, these regimes can shift the cost of the sanctions from their support groups to other members of the population.⁴⁶ As Risa Brooks notes,

Authoritarian leaders have fewer incentives to respond to harm to mass constituencies because the threat these masses pose to the leaders' positions is more diffuse; moreover, when faced with pressure from below, the option to suppress (rather than act to alleviate) popular discontent is likely to be less costly and more readily available to authoritarian leaders than it is to democratic leaders.⁴⁷

Indeed, general sanctions imposed on an authoritarian regime can actually strengthen it vis-à-vis internal rivals. The regime can use the imposition of sanctions as a rallying cry and as an opportunity to seize power from internal rivals – perhaps to impose rationing or to ensure “fair distribution.” The remaining limited commerce can be directed to favored entities and denied to rivals. Precisely this sequence happened in the 1990s when Saddam Hussein's Baathist constituents continued to enjoy luxuries in the face of sanctions while the overall population increasingly languished under them. Arguably, by the end of the decade, because of the unintended consequences of sanctions, Saddam Hussein was less threatened by internal rivals than he had been at the start.⁴⁸

Targeting the overall population therefore will likely not have a direct effect, as it will not threaten the regime's core group of supporters and its means to retain power.⁴⁹ At the same time, there are significant downsides inherent in applying these comprehensive sanctions that prevent their effective implementation. In one sense, as scholars have noted, punishing the general population may have perverse consequences, causing a rally-around the flag effect that decreases the likelihood of target acquiescence.⁵⁰ In addition, and because they often target innocent bystanders (i.e. the general population) instead of the culpable party (i.e. the ruling party or government), these sanctions can be harder to sell and sustain to domestic groups and allies. In the late 1990s, the international sanctions regime against Hussein began to collapse, not because Hussein convinced the rest of the world that he was no longer a threat but because he had effective propaganda suggesting that the pain born by ordinary Iraqis was excessive.⁵¹

46 William Kaempfer and Anton Lowenberg, *International Economic Sanctions: A Public Choice Perspective* (Boulder: Westview Press, 1992). See also William Kaempfer, Anton Lowenberg and William Mertens, “International Economic Sanctions Against a Dictator,” *Economics and Politics* Vol.16, No.1 (2004), pp.29-51.

47 Brooks (2002), p.17. See also David M. Rowe, *Manipulating the Market: Understanding Economic Sanctions, Institutional Change, and the Political Unity of White Rhodesia* (Ann Arbor: The University of Michigan Press, 2001). However, different types of authoritarian regimes may have different levels of vulnerability to sanctions. Personalist regimes and monarchies may be destabilized by economic sanctions because they need the revenue to fund patronage; but single-party authoritarian regimes and military dictatorships may have more state capacity at their disposal that they can use to mitigate or divert the pain. See Abel Escriba-Folch and Joseph Wright, “Dealing with Tyranny: International Sanctions and the Survival of Authoritarian Rulers,” *International Studies Quarterly* Vol.54, no. 2 (June 2010), pp.335-360.

48 Note, however, that this does not necessarily mean that the sanctions overall “failed.” The sanctions did make it harder for Hussein to produce WMD and, we now know, convinced him to suspend some development programs until such time as he could get out from under the sanctions' (and inspections) watchful regime. See, “Comprehensive Report of the Special Advisor to the DCI on Iraq's WMD,” 30 September 2004 also known as the “Duelfer Report.”

49 Brooks (2002), p.2.

50 Richard Haass, “Sanctioning Madness,” *Foreign Affairs* Vol.76, No.4 (1997).

51 On the debate about whether the number of Iraqi children killed by sanctions in the 1990s, see Barbara Crossette, “Iraq Sanctions Kill Children, U.N. Reports,” *New York Times*, 1 December 1995. See also “Iraqi Children Starving Under Sanctions,” *BBC News*, 27 November 1997. <http://news.bbc.co.uk/2/hi/35065.stm>. On the less-than-deft handling of the topic, see Madeleine Albright, *Madame Secretary* (New York: Hyperion, 2003), pp. 274-275.

Ironically, the world, or at least key elites in Europe and elsewhere, proved more responsive to the pressure of ordinary Iraqis than did Hussein himself. Because they can often result in large numbers of innocent deaths other actors may be more reluctant to impose them.⁵²

The limitations of general sanctions became apparent throughout the 1990s and led to the increased use of targeted sanctions – sanctions which focus the coercive leverage more directly on elite parties, either the political leadership directly or the ‘transmission belts’ of their supporters helping to keep them in power.⁵³ This feature makes them more appropriate for use against authoritarian regimes because the supporting elements of the regime can be more specifically targeted for greater coercive effect.⁵⁴ Yet targeted sanctions also have limitations. First, restricting the category of items banned may reduce collateral damage, but it also tends to reduce the overall pain inflicted.⁵⁵ For example, one common form of targeted sanctions involves bans on sports teams and the prevention of foreign travel by leaders of the target-state. While conveying some symbolic opprobrium, such limited measures are not likely to impose enough pain to change the decision-calculus of the leadership.⁵⁶ Second, targeted sanctions can be self-limiting. For example, freezing the financial assets of key individuals is a powerful way to put the pain directly “on target.” But once threatened, those individuals will likely move their assets so as to avoid being frozen. Moreover, others who might be plausible targets for future pressure have both motive and opportunity to change their financial portfolio to make them less vulnerable to this tactic. Precisely this dynamic occurred in the late 1990s when the UN began imposing such freezes.⁵⁷ As a result, even though initial seizures may have been successful, follow-on attempts to ratchet up pressure were infeasible because the assets could not longer be effectively targeted. This undercuts one of the core requirements of coercive diplomacy – the need to credibly threaten to ratchet up pressure on the target.

One final limitation has already been suggested in the foregoing: sanctions depend on the cooperation of allies to have full effect. With any form of coercion the immediate effect of the coercive pressure is to drive the target to seek ways of reducing the pain short of conceding the issue in dispute. In the case of economic sanctions, the easiest way to reduce the pain without conceding is to find someone else to supply or make whole whatever the economic sanction has denied the target, hence the desirability of multilateral (imposed by many) versus

Authoritarian leaders have fewer incentives to respond to harm to mass constituencies because the threat these masses pose to the leaders’ positions is more diffuse

52 John Mueller and Karl Mueller, “Sanctions of Mass Destruction,” *Foreign Affairs* Vol.78, No.3 (1999), pp.43-53.

53 Arne Tostensen and Beate Bull, “Are Smart Sanctions Feasible?” *World Politics* Vol.54 (2002), pp.379-382. On the point about transmission belts, see both Blanchard and Ripsman (1999) and Kirshner (1997).

54 Interestingly, targeted sanctions can also be very effective in democracies if the particular target is important to the party in power, such as an export industry. Indeed, it appears that overall, targeted sanctions work against both authoritarian and democratic regimes, whereas comprehensive sanctions are likely to work only against democratic ones.

55 For example, Shagabudinova and Berejikian found that some types of targeted sanctions were often of a shorter duration and therefore brought less pressure to bear on their targets. Ella Shagabudinova and Jeffrey Berejikian, “Deploying Sanctions while Protecting Human Rights: Are Humanitarian “Smart” Sanctions Effective?” *Journal of Human Rights* Vol.6 (2007), pp.59-74. See also Dominic Tierney, “Irrelevant or Malevolent? UN Arms Embargoes in Civil Wars,” *Review of International Studies* Vol.31 (2005), pp.645-664.

56 Drezner (2010), p.12.

57 For example, in 1998, the UN Security Council passed Resolution 1173, attempting to target Angola’s UNITA leadership by identifying the funds of top leaders for seizure. Rather than allowing this to happen, elites merely shifted control of their accounts to lower-level UNITA officers who were not directly targeted and therefore avoided having their funds confiscated. David Cortright & George Lopez, *Sanctions and The Search for Security* (London: Lynne Rienner, 2002), chpt.6.

unilateral sanctions to close off avenues of escape.⁵⁸ Indeed, scholars have found that sanctions are more likely to succeed when the target's main trading partners support the sanctions or are imposing the sanctions.⁵⁹ However, the history of economic sanctions is a sorry history of weak multilateral cooperation and resolve.⁶⁰ By definition, multilateral sanctions will involve actors who are less strongly committed to the cause and these are the weak links that the target state will seek to exploit to evade the sanctions. In theory, then, the best sanctions would be ones that are self-reinforcing, or that are easily imposed even by weakly committed partners.

The overall picture then is one of somewhat limited effectiveness of different types of sanctions, increased or decreased depending on the type of sanction and target. Sanctions will likely be ineffective in achieving ambitious foreign policy goals and comprehensive sanctions are better aimed at democracies, whereas targeted sanctions are better aimed at autocracies.⁶¹ For a visual representation of these differences, see figure 1.

Figure 1		
	Pros	Cons
Ideal Sanctions	<ul style="list-style-type: none"> – Imposes Significantly More Costs on Target Than Sender – Difficult to Work Around for Target – Easy for Allies to Support – Pain Inflicted Increases Over Time – Pain is Focused on Decisionmakers and the Selectorate – Pain is Focused on Items the Selectorate Values 	
Comprehensive Sanctions	<ul style="list-style-type: none"> – Can involve great pain 	<ul style="list-style-type: none"> – Difficult to Impose – Difficult to Sustain (Civilians) – Ethical concerns – Easy to Circumvent
Targeted Sanctions	<ul style="list-style-type: none"> – More Direct Pressure on Elites – Less Collateral Damage – More Sustainable 	<ul style="list-style-type: none"> – Decreasing Utility Over Time (Enemy Learning) – Limited Leverage

New Economic Sanctions and Reputation in International Politics

In addition to posing interesting questions for the literature on coercive diplomacy, the mechanisms by which these new sanctions operate also relate to the literature on reputation and international politics. These new financial sanctions generate at least two effects – a direct

58 See Navin Bapat and T. Cliff Morgan, "Multilateral Versus Unilateral Sanctions Reconsidered," *International Studies Quarterly* Vol.53, No.4 (2009), pp.1075-1094.

59 Elena V. McLean and Taehee Whang, "Friends or Foes? Major Trading Partners and the Success of Economic Sanctions," *International Studies Quarterly* Vol.54, No.2 (June 2010), pp.427-447.

60 For more on the necessity and limits of multilateral approaches to sanctions, see Lisa Martin, *Coercive Cooperation: Explaining Multilateral Economic Sanctions* (Princeton: Princeton University Press, 1993). See also Daniel Drezner, "Bargaining, Enforcement, and Multilateral Sanctions: When is Cooperation Counterproductive?" *International Organization* Vol.54, No.1 (2000), pp.73-102.

61 For an interesting and comprehensive account of these types of sanctions, their respective causal mechanisms, and how should policymakers should utilize them in an "eclectic" manner; see Daniel Drezner, "An Analytically Eclectic Approach to Sanctions and Nonproliferation," Manuscript (2010), pp.11-14.

effect imposed on the targeted institution by the sender state (the United States government and its partners) and an indirect effect imposed by the rest of the financial system. The indirect effect leverages reputation, specifically the reputational concerns that banks and other financial institutions have about dealing with tainted (“designated”) entities. Scholars have studied how reputation works in international politics and in international business and some of the insights from this literature help illuminate the prospects and limits for these new sanctions.

Scholars of international politics have had a lively debate as to whether reputation even matters; scholars of international business, by contrast, have a clear consensus on the importance of reputation. The apparent contradiction across the two literatures may simply be a function of the different objects of study; in international politics, the focus is on states and governments whereas in international business the focus is on commercial corporations. It is possible in theory that reputational effects are substantial in the commercial world and insubstantial in the political world. But the academic debate within the international politics realm has one more feature of note for our purposes: practitioners of international politics have long emphasized the importance of reputation in explaining and justifying their policies whereas scholars have been hard-pressed to identify and measure reputational effects anywhere near as substantial as the policymakers believe.⁶²

The classical scholarship on reputation in international politics tracked closely with the intuitive understanding of statesmen. Thucydides records in the Melian Dialogue that the Athenians worried that if they let the islands resist their power they would acquire a reputation for weakness, “As far as right goes they think one has as much of it as the other, and that if any maintain their independence it is because they are strong, and that if we do not molest them it is because we are afraid; so that besides extending our empire we should gain in security by your subjection; the fact that you are islanders and weaker than others rendering it all the more important that you should not succeed in baffling the masters of the sea.”⁶³ Similarly, Machiavelli warned his Prince, “Not to fear the reputation of being mean, for in time he will come to be more considered than if liberal, seeing that with his economy his revenues are enough, that he can defend himself against all attacks, and is able to engage in enterprises without burdening his people.”⁶⁴

Under the shadow of a global Cold War between two superpowers – where the strength and resolve of leaders seemed to be tested from the jungles of Southeast Asia to the narrow streets of Berlin – a new science of international politics focused on credibility and reputation emerged from defense think tanks and universities. The most important work in this first wave of modern research was by Thomas Schelling. It drew on mathematical game theory to argue that, “Our threats are interdependent. Essentially we tell the Soviets that we have to react here because, if we did not, they would not believe us when we say that we will react here... the loss of face that matters most is the loss of Soviet belief that we will do, elsewhere and subsequently, what we insist we will do here and now.”⁶⁵

62 See Shiping Tang, “Reputation, Cult of Reputation, and International Conflict,” *Security Studies* Vol. 14, No. 1 (October 2005), pp.34-62.

63 Thucydides, *Melian Dialogue*.

64 Niccolò Machiavelli, *The Prince*, Chapter XVI, Concerning Liberality and Meanness.

65 Schelling (1966), pp.55-56.

A subsequent wave of research, however, argued that what worked in game theory did not work in historical practice. Jonathan Mercer, for example, in *Reputation and International Politics* used social psychology to attack the purported causal mechanism of reputation formation in international relations.⁶⁶ Mercer argued that the fundamental attribution error (FAE) and wishful thinking both distort how reputations form. The FAE involves a propensity to view behavior from your in-group (yourself and your allies) in a systematically different way from how one views behavior from the out-group (others, especially adversaries). When the in-group actor does something favorable, we credit this to disposition, which can function as reputation: they are “that type” of actor. When the out-group actor does something favorable, we credit this to situation: circumstances forced them, so they are not really “that type” and no reputation adheres. Conversely, when an in-group actor does something unfavorable, we credit it to situation (the devil made me do it); when an out-group actor does something unfavorable, we are inclined to view that as confirming the adversaries’ bad type. Similarly, states that do what a leader wants do not form a reputation (e.g. if an enemy backs down, next time we will not necessarily think of him as weak) while states that do not do what a statesmen wants can form a reputation (e.g. an ally can form a reputation for being weak-willed when it does not stand up to our mutual enemy). Because of these two effects, according to Mercer, fighting to preserve a reputation vis a vis

When the in-group actor does something favorable, we credit this to disposition, which can function as reputation: they are “that type” of actor

an enemy is pointless – enemies will not credit us accordingly. To empirically substantiate these claims, Mercer examined diplomatic correspondences from the First Moroccan and the Agadir crises and found that statesmen attempting to attain reputations for resolve in the eyes of their adversaries were unable to achieve their objective.⁶⁷

Echoing this point, Daryl Press, in *Calculating Credibility*, attacked the argument that reputations for resolve matter in the minds of adversaries; in addition to directly critiquing the causal mechanism of reputation formation, he examined the empirical record of how policymakers take decisions and whether reputation plays an important role.⁶⁸ Press focused on military crises and argued that reputation does not play a role between states in a series of chronologically and substantively proximate crises. Similarly, Press examined the importance of allied reputation for resolve during the 1938-39 crises, the various Berlin crises in the late 1950s and early 1960s, and the Cuban Missile Crisis, and found that in each of them, decisionmakers did not consider the reputations of their adversaries when choosing their courses of actions.

To be sure, some scholars did find reputational effects in international security contests. Todd Sechser examined small states’ puzzling decision to fight much larger states and found that the desire to establish a reputation for resolve (to prevent future aggression on the part of the larger state) caused those small states to fight conflicts they were almost certain

⁶⁶ Jonathan Mercer, *Reputation and International Politics* (Ithaca: Cornell University Press, 1996).

⁶⁷ For a good critique of Mercer’s theoretical arguments and his research design, see Dale Copeland, “Do Reputations Matter?” *Security Studies* Vol.7, No.1 (1997), pp.33-71. See also Patrick Morgan, “Getting Respect Gets No Respect,” *Mershon International Studies Review* Vol.41 (1997), pp.117-119.

⁶⁸ Daryl Press, *Calculating Credibility* (Ithaca: Cornell University Press, 2005).

to lose.⁶⁹ Mark Crescenzi, conducting a large-N study of all countries and their relations between 1817 and 2000, examined how states processed information in the international system and found that reputations (in the form of prior actions) had a significant effect on the likelihood of conflict behavior.⁷⁰ But on balance, scholars suggest that reputation matters less in international contests than the practitioners have believed.

More recent scholarship looking at international political economy instead of international security has reached a very different conclusion. Michael Tomz examined the theoretical debate raised by Schelling, Mercer, and Press and, based on his sweeping study of several hundred years of international lending practices has claimed, "The empirical evidence... points overwhelmingly in one direction.... reputations have formed in consistent ways and profoundly influenced the flow of international capital."⁷¹ In *Reputation and International Cooperation*, Tomz examined the behavior of creditors and borrowers, specifically the relationship between sovereign governments and private foreign lenders and their use of debt contracts.⁷² He argued that borrowers, to an extent, gain or lose credibility based on their prior action (reputation).⁷³ Other scholars within the field echo the importance placed on reputation, particularly in the examination of why and how international institutions and laws are credible and create compliance.⁷⁴

This dichotomization (i.e. reputation matters for institutions, finance, legal and economic issues whereas it does not matter as much for security concerns) is problematic. Why would statesmen necessarily believe reputation is valuable in one realm but discount it in another? One answer might be that security concerns are the domain of statesmen, where reputation matters less whereas political economy are the concerns of private creditors where reputation matters more. This explanation would find support from the business journal literature that deals with private sector firms' concerns about their own reputation and how it affects their own behavior.⁷⁵ This literature – largely unconsulted in the academic debates referenced above – suggests that reputation can play a powerful role in affecting a firm's profit margin, as well as influencing the decision-making of CEOs. For example, research indicates that possessing a positive reputation can significantly increase a firm's stock prices and return on assets and that this reputation can provide a distinct advantage for firms because it is often difficult to imitate by competitors.⁷⁶ In addition, this reputation,

69 Todd Sechser, "Goliath's Curse: Asymmetric Power and the Effectiveness of Coercive Threats," *International Organization*, Forthcoming.

70 Mark Crescenzi, "Reputation and Interstate Conflict (Of Friends and Foes)," *American Journal of Political Science* Vol.51, No.1 (2007).

71 Michael Tomz, *Reputation and International Cooperation* (Princeton: Princeton University Press, 2007), p.36.

72 *Ibid.*, p.3.

73 *Ibid.*, pp.14-27.

74 See, for example, Beth Simmons, "International Law and State Behavior: Commitment and Compliance in International Monetary Affairs," *American Political Science Review* Vol.94, No.4 (December 2000). Helen Milner, "Globalization, Development and International Institutions: Normative and Positive Perspectives," *Perspectives on Politics* Vol.3, No.4 (December 2005).

75 The emphasis of the business literature is different from Tomz's approach, which focuses on creditors' assessments of states' reputations. Rather, the business literature focuses on creditors' (and private business actors more generally) concerns about the effect of their own reputations. Interestingly, as policymakers developing these new financial sanctions suggest, the lack of discussion of the power of the private sector in much of the previous literature on sanctions is surprising, as influencing the actions of these organizations may grant extra coercive power to states. Interview with senior official.

76 In this literature, reputation is defined as, "A perceptual representation of a company's past actions and future prospects that describes the firm's overall appeal to all of its key constituents when compared with other leading rivals." Siah Hwee Ang and Ana-Maria Wright, "Building Intangible Resources: The Stickiness of Reputation," *Corporate Reputation Review* Vol.12, No.1 pp.21-32. P.V. Roberts and G.R. Dowling, "Corporate Reputation and Sustained Superior Financial Performance," *Strategic Management Journal* Vol.23, pp.1077-1093. See also R.C. Vergin and M.W. Qoronfleh, "Corporate Reputation and the Stock Market," *Business Horizon* Vol.41, pp.19-26.

though often difficult to obtain, can be easily damaged, and negative reputations can be particularly sticky.⁷⁷ Beyond affecting the bottom line of companies, surveys of corporate CEOs reveal that these business leaders perceive the reputation of their company as one of the three most important intangible factors in accounting for business success, suggesting that these individuals make decisions based on the likely impact on this asset.⁷⁸ In sum, even more so than in the literature on institutions and finances, and in stark contrast to the literature on security, reputation plays a crucial role in corporate decision-making.

This apparent harmonization of the various literatures – reputation matters when dealing with political-economic issues involving private corporations but not when dealing with security concerns involving governments – would raise interesting questions for the new financial sanctions, which straddle both. It might suggest, for instance, that these sanctions would be easier to impose than traditional sanctions that rely on government decisions because governments are more willing to ignore the reputational costs of continuing to deal with rogue proliferators. It might also suggest that the new sanctions would be more effective because private institutions in the targeted country would be more responsive than the targeted government.

But the apparently conflicting findings may also simply reflect an underlying confusion in the academic literature. Indeed, as George Downs and Michael Jones have suggested in theoretical work, “There are a number of empirical and theoretical reasons for believing that the actual effects of reputation are...more complicated than the standard view of reputation suggests.”⁷⁹ Moreover, research in progress may be uncovering reputational effects in the security domain that the existing literature missed. A forthcoming dissertation by Kathryn Cochran argues that reputation does matter in certain security situations: specifically, third parties observe conflicts and, depending on the result, draw inferences about the resolve and toughness of the warring parties, much as how first-generation reputation theories like the domino theory suggested.⁸⁰

The dogged insistence by practitioners that reputation matters, even for statesmen and even in the security domain is another reason to be cautious about inferences from the academic literature. For example, in discussing the need to deploy more troops to Afghanistan, a British general recently declared that, “Credibility with the US is earned by being an ally that can be relied on to state clearly what it will do and then does it effectively. And credibility is also linked to the vital currency of reputation.”⁸¹ It is of course possible that all of those practitioners are wrong. But it is also possible that more academic political science has not found a reliable way to measure reputation. It is a certainty, however, that the new financial sanctions seek to leverage reputational effects in ways that the existing academic literature only dimly anticipates.

77 Richard Hall, “A Framework Linking Intangible Resources and Capabilities to Sustain Competitive Advantage,” *Strategic Management Journal* Vol. 14, pp.607-618. G.R. Dowling, “Corporate Reputations: Corporate Reputations: Should You Compete on Yours?” *California Management Review* Vol.46 (2004), pp.19-36. On the argument that reputations are sticky, see R.C.Vergin and M.W. Qoronfleh, “Corporate Reputation and the Stock Market,” *Business Horizon* Vol.41, pp.19-26.

78 The other two are product reputation and employee know-how. Richard Hall, “The Strategic Analysis of Intangible Resources,” *Strategic Management Journal* Vol.13, No.2 (Feb 1992), pp.135-144.

79 George Downs and Michael Jones, “Reputation, Compliance and International Law,” *Journal of Legal Studies* Vol.XXXI (January 2002), p.595.

80 Kathryn Cochran, “Strong Horse or Paper Tiger? Assessing the Reputational Consequences of War Fighting,” Ph.D. dissertation, Duke University, forthcoming.

81 “More British troops needed in Afghanistan ‘to safeguard reputation with US’” *Telegraph.co.uk*. 1 June 2009. <http://www.telegraph.co.uk/news/newstopping/onthe前线/5419993/More-British-troops-needed-in-Afghanistan-to-safeguard-reputation-with-US.html>. Accessed 28 June 2010.

CHAPTER 2

A SHORT HISTORY OF THESE NEW TYPES OF SANCTIONS

A significant, if under-publicized part of the domestic and international response to the 9/11 terrorist attacks involved dramatic changes to the international financial regulatory framework. Both private and governmental actors redoubled efforts to “build and adapt legislative, regulatory, and financial enforcement tools to prevent terrorist financing.”⁸² This shift opened the door to a new form of ‘regulatory’ sanctioning by the international community against states such as Iran and North Korea.

The first significant step expanding the government’s ability to freeze the assets and block the transactions of terrorist organizations and supporters, including designated financial institutions, was the signing of executive order 13224 by President Bush on Sept. 22, 2001.⁸³ Additional anti-money-laundering tools targeted at countering cash flows to terrorist organizations were created and strengthened by the PATRIOT Act and the October 2001 Eight Special Recommendations of the Financial Action Task Force (FATF), the thirty-four member body that sets global standards on combating money-laundering. These tools were institutionalized when the Office of Terrorism and Financial Intelligence of the Department of Treasury, dedicated to gathering financial information and analysis for use in policy making and by the private sector, was established in 2004.⁸⁴ The implementation of these new regulations eventually motivated financial institutions to terminate relations with suspect businesses, even absent government mandates, to “protect the integrity of the international financial system”⁸⁵ – in effect making the prevention of terrorist activities simply prudent business practice. Indeed, as a senior official involved in counter-terrorism put it: “In the post 9/11 world, the banks were terrified of being caught doing wire transfers for Mohammed Atta.”⁸⁶ The framework for these new regulations was adopted by the international community and enforced against institutions like Riggs Banks, UBS, and ABN

82 Juan C. Zarate, “Harnessing the Financial Furies: Smart Financial Power and National Security,” *The Washington Quarterly* Vol.32, No.4 (2009), p.44.

83 *Ibid.*, p.47.

84 *Ibid.*, p.45.

85 *Ibid.*, p.50.

86 Interview with senior official.

Amro of the Netherlands. In the latter case, the U.S. imposed a US \$80 million fine for failing to ensure compliance against the WMD programs of Libya and Iran.⁸⁷ It was in this broader regulatory context that these new levers of coercive diplomacy were applied.

The 9/11 attacks may have been the catalyst for strengthening this regulatory regime and the tools were wielded extensively on the Al Qaeda network of terrorist affiliates, but of special interest to this study, states who were not directly involved in the 9/11 attacks were also caught in the net.⁸⁸ In particular, the tools were used with considerable effect on two “rogue states” suspected of pursuing weapons of mass destruction, North Korea and Iran. In both cases, the world community, but especially the United States, had sought for decades with very little success to pressure the regimes into abandoning WMD programs and suspending other illegal activities. Both were already subject to myriad conventional sanctions, but in the post-9/11 environment, both came to feel the bite of the new financial levers.

North Korea

The conflict between the United States and North Korea has lasted over half a century, and North Korea is subject to a great amount of economic pressure by the United States. In September 2005, the U.S. began to utilize the new tools against North Korea when the Treasury Department, acting under Section 311 of the PATRIOT Act, ordered American financial institutions to close all accounts for Banco Delta Asia (BDA) of Macau, a bank well known for facilitating North Korean money laundering and proliferation activities.⁸⁹ The international financial community observed the actions of the U.S., and without any prompting from the government or UN, soon a reported two dozen banks in Asia and Europe ended or reduced their business relations with Pyongyang, closing accounts, canceling transactions, and investigating officials’ financial activities; the private sector effectively cut North Korea off from the international financial system.⁹⁰

This initial pressure triggered a ratchet effect when the Macau government – perhaps out of concern that the U.S. would start targeting other Macau institutions if they did not police themselves more vigorously – placed the bank in receivership, freezing \$24 million in funds owned by North Korea.⁹¹ This left the North Korean regime scrambling to gain access to international funds and accounts. Though China was critical of the new intensity of U.S. sanction policies, even the Chinese government refused to help North Korea create alternative access points to the international financial system and thereby rescue it from the financial sanctions.⁹² The pressure experienced by North Korea as a result of these sanctions helped prompt them to return to the Six-Party talks and, after the money was returned, to proceed in closing the Yongbyon nuclear facility.⁹³

87 Michael Jacobson, “Sanctions Against Iran: A promising struggle,” *The Washington Quarterly* Vol.31, No.3 (2008), pp.73-74. Zarate (2009), p.46.

88 For a scathing critique of the entire war on terror as anti-Islamic, with a special emphasis on these tools, see Ibrahim Warde, *The Price of Fear: The Truth Behind the Financial War on Terror* (Berkeley: University of California Press, 2007).

89 For a good account of these activities see <http://www.ustreas.gov/press/releases/js2720.htm> (accessed on 16 June 2010).

90 Jacobson (2008), p.72. See also Zarate (2009), p.51. Steven Weisman, “The Ripples of Punishing One Bank,” *New York Times* 3 July 2007.

91 Jacobson (2008), p.72. Weisman, (2007).

92 Zarate (2009), p.51. And Jacobson (2008), p.73.

93 Jacobson (2008), p.72. And Zarate (2009), p.51.

However, the sanctions proved so effective that they created a problem for the United States. When the North Koreans indicated a willingness to follow on the 5th round of the Six-Party talks in March of 2007, they set as a condition that the United States first had to return the dollars that had been seized in the Banco Delta Asia action. This request set off a vigorous debate within the U.S. government, with some willing to return the money as a way of facilitating the diplomatic initiative and others arguing that it would be unwise, in part because it would not likely induce North Korean concessions but especially because of the prosecutorial discretion it would require to return money that had been seized under this regulatory framework. Although the diplomatic faction won the internal debate, the United States then discovered that the rest of the international financial community was not persuaded. On the contrary, each institution the U.S. government approached with a request to transfer the money back to North Korea refused to facilitate the transaction on the grounds that doing so would expose them to the very legal liability that was used to seize the money in the first place.⁹⁴ Somewhat to the embarrassment of the United States, these funds were now deemed “hot money” and ultimately the United States had to get the Federal Reserve Bank of New York to transfer the money to the Russian Central Bank and then the Far Eastern Bank in Vladivostok to return the money and avoid legal and reputational liabilities.⁹⁵

The re-started talks did not lead to an ultimate diplomatic settlement, however, and on June 12, 2009 the UN again used this power to pressure North Korea, and adopted Security Council resolution 1874 that served to increase financial pressure, amplified the arms ban, and outlined a new system of inspection of North Korean cargo.⁹⁶ The Treasury Department then advised the international community of the dangers of doing business with North Korea, citing numerous suspicious North Korean Banks believed to be facilitating the nuclear weapons program.⁹⁷ The U.S. hoped that the use of these new types of sanctions against North Korea would send a strong message to Iran, and, “As one senior Bush administration official commented, ‘[Y]ou can be sure that other countries like Iran will be drawing lessons from North Korea. What Banco Delta Asia demonstrates is that once you find yourself in this tar pit, it’s almost impossible to extract yourself.’”⁹⁸

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Iran

Six administrations since 1979 – from Jimmy Carter to Barack Obama – have confronted a hostile Iranian regime, and all have failed to persuade or coerce the regime to change its behavior the way the United States (and much of the international community) would like. One particularly intractable problem has been Iran’s development of a nuclear energy program

⁹⁴ Weisman (2007).

⁹⁵ Weisman (2007). And in so doing, the United States had to promise not to apply the money laundering laws to the Russian banks, even though technically they were in violation of those laws when they helped the United States in this fashion. Interview with former senior official.

⁹⁶ Zarate (2009), p.51.

⁹⁷ Zarate (2009), pp.51-52.

⁹⁸ Weisman (2007). Jacobson (2008), p.73.

that many suspect will be used for weapon production. Yet the possible solutions to the problem have either been unappealing or ineffective – in particular the traditional economic sanctions imposed unilaterally by the United States and under multilateral auspices by the United Nations. According to senior administration officials, this frustration with the speed of the process led the Bush team to seek new levers of coercive power – particularly financial ones – that might prove more effective.⁹⁹ In February 2006, Stuart Levey, Under Secretary of

UNSCR 1737 blacklisted ten Iranian entities and twelve individuals with ties to the nuclear or ballistic missile program

Treasury for Terrorism and Financial Intelligence, coordinating closely with his counterparts at the State Department, began advocating an alternative method of employing these new sanctions against the Iranian government.¹⁰⁰ Inspired by the January announcement of Swiss Bank UBS AG to cut ties with Iranian businesses due to increased costs as a result of regulatory and security uncertainty, Treasury and State Department officials proposed using ties with the private sector to enforce 'regulatory' sanctions.¹⁰¹

These coordinated efforts were received enthusiastically by the Bush administration, and Levey began a string of visits to more than five-dozen banks to persuade them to reconsider their business positions with Iranian banks.¹⁰² In conjunction with his visits, the State Department also actively worked with the host governments of the countries in which these legitimate banks were based to ensure they were on board and willing to allow the Treasury Department presentations.¹⁰³ By highlighting specific transactions made by Iranian banks, such as the US \$50 million transferred from, "Iran's Bank Saderat through a London subsidiary, to a Hezbollah affiliated charity in Lebanon," Levey revealed to the banks the potential for high costs if they were discovered to be facilitating illicit Iranian transactions.¹⁰⁴ The Treasury Department began blacklisting – "barring from direct or indirect business with U.S. banks" – Iranian banks like Saderat in 2006, Bank Sepah in 2007, and later Bank Melli, Iran's largest Bank; soon other nations began to do the same, despite Iranian protest.¹⁰⁵ In October 2007, as the the Iranian Revolutionary Guard Corps' (IRGC) exercised an increasing level of control over a wide area of the Iranian economy, such as oil, defense production, and construction industries, the U.S. Departments of State and Treasury designated, "The IRGC, nine IRGC front companies, five leaders, the Ministry of Defense and Armed Force Logistics, and Bank Melli and Bank Mellat as proliferators of weapons of mass destruction, while the IRGC-Qods force and Bank of Saderat were designed as supporters of terrorism."¹⁰⁶

In 2006 UN Security Council sanction resolutions began to feature actions against Iranian banks. UNSCR 1737 blacklisted ten Iranian entities and twelve individuals with ties to the nuclear or ballistic missile program.¹⁰⁷ In March of 2007, the council passed UNSCR 1747, which banned additional companies and officials of the IRGC, designated Bank Sepah

99 Interviews with former senior officials.

100 Robin Wright, "Stuart Levey's War," *The New York Times* 2 November 2008, pp.1, 3.

101 *Ibid.*, p.1.

102 *Ibid.*, p.3. Also Jacobson (2008), pp.72-73.

103 Interview with former senior official.

104 Wright (2008), p.3. And Zarate (2009), p.44.

105 Wright (2008), p.5.

106 Zarate (2009), pp.52-53.

107 Wright (2008), p.3. Jacobson (2008), p.75. UNSCR 1737 passed by a unanimous vote in the Security Council.

as subject to sanctions, and placed a one-way arms embargo, prohibiting exports.¹⁰⁸ The third round of sanctions, passed in March 2008 with UNSCR 1803, expanded the blacklist and called on countries to increase their vigilance over cargo bound to or from Iran and over financial institutions with regard to their business with Iranian banks.¹⁰⁹ This multilateral effort has continually increased the pressure on Iran; in June 2010, the UN Security Council passed UNSCR 1929, which, among other steps, identified more entities and officials engaged in proliferation and terrorism-related activities and called on states to, “prevent any financial service – including insurance or reinsurance – and freeze any asset that could contribute to Iran’s proliferation.”¹¹⁰

Other international action expanded upon the UN steps. In June 2008 the EU blacklisted Melli and froze its assets, and in November 2008 Australia sanctioned Melli and Saderat, as the U.S. blacklisted the Export Development Bank of Iran.¹¹¹ More recently, during the summer of 2010, the EU has gone beyond the requirements of UNSCR 1929, identifying dozens of Iranian officials, banks and companies affiliated with the IRGC and the shipping industry and banning EU companies from conducting business with them.¹¹² Unilateral action by the United States also proved to be more effective than waiting for the Security Council to reach a decision because Russia and China pushed to postpone decisions in the hopes that Iran would display more cooperation in efforts by the IAEA.¹¹³ However, eventually large banks in Britain, France, Germany, Japan, Italy, Malaysia, Bahrain, other Muslim countries, and even China cut back their business with Iran. As of November 2008, over eighty banks had followed suit.¹¹⁴ The news of Iran’s insecure position in the global financial system then spread beyond banks and individual nations to groups like the Financial Action Task Force (FATF), and the Organization for Economic Cooperation and Development.¹¹⁵ In October 2007, and February 2008, the FATF put two warnings on Iran, made calls for members to take actions to protect their financial systems against the dangerous Iranian financial system, and urged Iran to address the shortcomings in its anti-money laundering regimes.¹¹⁶ Following UNSCR 1929 in the summer of 2010, Treasury designated another major Iranian bank, as well as Iranian shipping companies, as subject to sanctions.¹¹⁷ Indeed, according to Under Secretary of the Treasury Stuart Levey, the purpose of the new round of sanctions was to continue this process of incrementally raising the pressure on Iran by continually finding and cutting off their access to international business.¹¹⁸ Simultaneously, the U.S. allies also began cutting their business ties with Iran and tightening the sanctions

One particularly intractable problem has been Iran’s development of a nuclear energy program that many suspect will be used for weapon production

108 Jacobson (2008), p.75. UNSCR 1747 passed by a unanimous vote in the Security Council.

109 Jacobson (2008), p.75. UNSCR 1803 passed by a vote of 14-0-1, with Indonesia as the single abstention.

110 UNSCR 1929. For a fact sheet illustrating the major provisions of the resolution, see http://www.cfr.org/publication/22433/un_security_council_resolution_1929_iran.html Accessed 4 September 2010.

111 Wright (2008), p.3.

112 Stephen Castle, “Europe Imposes New Sanctions on Iran,” *New York Times* 26 July 2010.

113 Jacobson (2008), p.73.

114 Wright (2008), p.6.

115 Ibid, p.4. And Zarate (2009), p.53.

116 Jacobson (2008), p. 76.

117 Mark Landler and Stephen Castle, “U.S. and Europe Press Tighter Sanctions on Iran,” *New York Times* 16 June 2010.

118 Michael Hirsh, “On Iran Sanctions, Incrementalism Rules,” *Newsweek* 16 June 2010.

vice; in September 2010, Japan and South Korea both announced sanctions on banks and individuals suspected of involvement in proliferation activities and thereby significantly limited Iran's business transactions in those countries.¹¹⁹

These international efforts have also been supplemented by U.S. domestic legislation meant to tighten the vice on Iran and deter business institutions from continually conducting business with the country. Most recently, Congress passed the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010, which, building off of the Iran Sanctions Act of 1996, significantly increases the liability and penalties for firms engaged in business in Iran.¹²⁰ For example, the new Act applies sanctions to any parent U.S. company which had actual knowledge or should have known that a subsidiary was involved in illicit transactions with Iran, giving companies increased incentives to monitor the actions of their business partners and ensure they are not engaged in any such business.

Banks and governments compliant with UN and U.S. sanction policies have also been collaborating in this effort, and states regularly feed intelligence about the nature of Iran's

Iran has not passively allowed these sanctions to eat away at its economy however, as recent reports indicate they have developed extensive mechanisms for working around limits on shipping and oil transport, especially in Dubai

illicit activities to banks that conduct business with them, or related enterprises.¹²¹ Since 2006, only twenty foreign banks continue to operate in Iran, down from a former forty-six, and from 2005 to 2006 alone Iran lost US\$ 5 billion in trade with the EU.¹²² Since the implementation of these regulation and sanctions, Iran has experienced significant financial and developmental challenges. Contrary to President Ahmadinejad's plans, the natural gas field Iran shares with Qatar has gone largely undeveloped on the Iranian side, and Tehran experienced great difficulty when trying to negotiate development contracts with foreign firms due to the banking pullouts.¹²³ Some predict that without major foreign investment, Iranian oil export could disappear by 2015.¹²⁴ Small businesses have been affected as well, having to pay cash for

imports in advance, with increased costs of twenty to thirty percent, and as the sanctions continue to display their strength, inflation rates have risen as high as thirty percent, for which Ahmadinejad faced public criticism from prominent members of the Iranian community, and protest from shopkeepers who barred their windows.¹²⁵ Levey also indicated that the Treasury Department was considering sanctioning industries other than banking, in particular, Iran's national shipping company, and the insurance industry.¹²⁶

Iran has not passively allowed these sanctions to eat away at its economy however, as recent reports indicate they have developed extensive mechanisms for working around

119 Choe Sang-Hun, "South Korea Aims Sanctions at 126 Entities," *New York Times* 8 September 2010.

120 For a copy of the act, see http://www.cfr.org/publication/22484/comprehensive_iran_sanctions_accountability_and_divestment_act_hr_2194.html Accessed 4 September 2010.

121 Zarate (2009), p.52.

122 Jacobson (2008), p.76.

123 Wright (2008), p.4.

124 Jacobson (2008), p.76.

125 Wright (2008), p.4. And Jacobson (2008), p.76.

126 Wright (2008), p.5. For a more recent example, see Landler and Castle (2010).

limits on shipping and oil transport, especially in Dubai.¹²⁷ But Iran has not enjoyed a completely free hand; the recent UNSCR 1929 explicitly targets Iran's attempts to hide its illicit transactions and network of front companies.¹²⁸ In Dubai as well, forty-eight international, local and family institutions have mostly cut off new business with Iranian banks listed in UN resolutions; the Dubai government has also set up a joint task force with the U.S. to uncover front companies for sanctioned Iranian entities and Iranian operatives have had a harder time obtaining visas and work permits.¹²⁹ With Bank Sepah "on the brink of collapse," Bank Saderat's number of banking relationships fell from twenty-nine in 2006 to eight in 2008, and other banks are suffering as well. Iranians are now turning back to tradition, to small Hawalas, informal versions of Western Unions, to access funds.¹³⁰ Also, Iran continues to increase their trade with China, trade through the UAE, and use small, second-tier banks that are more immune to the new financial levers.¹³¹

In an effort to defuse the sanctions and in particular the actions of the FATF, "Iran has enacted legislation to combat money laundering, and Iranian government officials claim that a 'supreme council' will be established to address these issues."¹³² However, it was to little avail, as the FATF rejected their attempt to lobby, deeming their reforms inadequate.

127 For examples of how Iran has circumvented the sanctions in Dubai, see Kambiz Foroohar, "Dubai Helps Iran Evade Sanctions as Smugglers Ignore U.S. Laws," Bloomberg 26 January 2010. For evidence of how Iran, with the help of European financial institutions, has circumvented U.S. financial obstacles, see Andrew Clark, "Lloyds Forfeits \$350 million for Disguising Origin of Funds from Iran and Sudan," The Guardian 10 January 2009.

128 UNSCR 1929. For a fact sheet illustrating the major provisions of the resolution, see http://www.cfr.org/publication/22433/un_security_council_resolution_1929_iran.html Accessed 4 September 2010.

129 Wright (2008), p.5.

130 Quote is from Jacobson (2008), p.76. See also Wright (2008), p.5.

131 Jacobson (2008), p. 78.

132 Ibid, p.76.

CHAPTER 3

NEW METHODS OF STATECRAFT: THE CAUSAL MECHANISMS UNDERLYING FINANCIAL SANCTIONS

All economic sanctions share in common the basic feature of coercion: the imposition of pain (or threatened pain) by the sender upon the target to change the target's behavior. But different sanctions may impose this pain in very different ways – what political scientists call “causal mechanisms.” For instance, the age old economic sanction known as the siege works in the following way: the sender physically interposes himself between the target and the target's sources of economic commerce, blocking by force any external commercial activity and thereby forcing the target to depend on (presumably limited) dwindling stockpiles. Provided that internal sources are limited, and that the target lacks the physical strength to break the siege, or lacks an ally that can, and provided that the sender does not wobble in his resolve, the pain escalates until the target dies or capitulates.

The new sanctions work according to somewhat different causal mechanisms from traditional sanctions and the differences may matter for an evaluation of effectiveness.

The Directness of the Leverage

The first axis of difference concerns the directness of the leverage created by the sanction. Traditional sanctions are direct, where the entity that decides to impose the sanction is also the entity imposing the sanction; the new sanctions are both direct and indirect, where the entity that decides to impose the sanction (the United States government), relies, at least to an extent, on the leverage created by other entities (the private sector) to help impose and intensify the sanction. The new sanctions are one more prominent example of

a more general phenomenon: the privatization of the security sector.¹³³ As Juan Zarate has explained, this phenomenon has migrated into the international financial sector:

A key dimension of this new paradigm is the central role and influence of the private sector for issues of international security import... Governments have relied more and more on the ability of financial institutions to act as protective gatekeepers to the financial system by identifying, reporting, and preventing the use of financial facilities by transnational actors and criminals of concern.¹³⁴

The new sanctions take this process one step further by having governments leverage the ordinary business practice of risk-management to suit governmental ends.

All businesses confront risk in their enterprise – risks that a natural disaster will destroy or delay valuable goods, risks that partners will not live up to their promises, risks that technologies will break down, risks that consumers will tire of once-desired goods, and so on. Successful companies do not avoid risk altogether so much as manage it and ensure that the prospective rewards of an activity exceed the prospective risks. Activities that are riskier can command a higher premium until the risks are so great that the activity simply is not worth doing at any price.

The new sanctions play upon one set of commercial risks: the risks of becoming complicit in tainted activity that expose the company to a reputation for being “dirty” or “shady” or even actual legal sanction for illicit practices. Companies tarred that way can find themselves facing a significant public or commercial backlash, and, in the extreme, may even confront bankrupting constraints – witness the fate of BP in the wake of the Gulf of Mexico oil spill. Hence, commercial entities will go some distance to avoid activity that would expose the company to such taint or, at a minimum, demand higher profit margins and so impose higher costs on others asking them to do the risky behavior.

The new sanctions hinge on a fact that policymakers hitherto failed to fully exploit: the international financial sector is especially sensitive to these sorts of reputational risks. Since all financial institutions are selling the same thing – a dollar is a dollar, whoever gives it to you – financial institutions distinguish themselves from the competitors in part by the rates they offer, but primarily by intangibles such as reputation and perceived trustworthiness. The “brand” of a bank is not so much the quality of the money but the quality of the overall reputation for confidential and prudent business practices. Legitimate commercial banks are especially wary about engaging in activity that will expose them to additional legal scrutiny, and so seek to avoid interacting with other commercial institutions that do so. Provided that there are other “safer” business opportunities, commercial institutions have an incentive to avoid dodgier activity.

The new sanctions thus designate (i.e. identify) one institution as “dirty,” which creates a powerful incentive for other institutions to take their business elsewhere, drying up the

¹³³ On this phenomenon, see Allison Stanger, *One Nation Under Contract: The Outsourcing of American Power and the Future of Foreign Policy* (New Haven: Yale University Press, 2009). Peter Singer, *Corporate Warriors: The Rise of the Privatized Military Industry* (Cornell: Cornell University Press, 2004), and Deborah Avant, *The Market for Force: the Consequences of Privatizing Security* (Cambridge: Cambridge University Press, 2005). Simon Chesterman and Chia Lehnardt, eds., *From Mercenaries to markets: The Rise and Regulation of Private Military Companies* (Oxford: Oxford University Press, 2007).

¹³⁴ Zarate (2009), p.49.

commercial opportunities of the dirty entity. The rest of the system responds this way not necessarily because they agree with the designation – and perhaps not at all because they sympathize with the larger political aims – but simply because they agree that if others think this particular entity might be tainted they do not want the taint on them. By analogy, designating an entity as tainted is akin to designating an individual as racist; other people, not wishing to be seen as racist as well, have a powerful incentive to avoid interacting with the tainted individual. The basic logic underpinning the implementation of these sanctions is to show legitimate commercial banks in Europe, Asia and the Middle East that their dealings with the banks and financial institutions of illicit actors pose a risk to their bottom lines. Indeed, according to Juan Zarate, “If financial entities act according to their own commercial interests, targeted actors and their fronts will be denied access to the facilities of the international financial system such as bank accounts, cross-border money transfers, and letters of credit.”¹³⁵ Thus, by appealing to banks’ business concerns, the United States aims to influence their decisions and their relationships with the illicit institutions of the target country. The purpose of this approach is to cause banks, concerned about these risky investments, to reduce their investments and therefore damage the economy of the target state. This damage, in turn, will hopefully either degrade the capabilities of the target state or bring it back to the bargaining table. Indeed, these sanctions offer the possibility of great effects with moderate effort; by changing regulations or implementing limited unilateral sanctions, the sender can leverage the power of the private sector and produce manifold returns.

The Focus of the Trigger

The essential step at the core of this approach is the designation of an entity as “dirty,” thus the second axis along which the new sanctions differ from the old ones: the focus of the sanction trigger. The old ones are what can be called politically based, whereas the new ones are “conduct-based.” The old sanctions are triggered by the target performing illicit behavior elsewhere and the sanctions domain is simply a convenient method of punishing: the Iranian regime is holding American’s hostage and so the U.S. government seizes money the Iranian regime has stored in U.S. banks. The new sanctions are triggered by the target engaging in illicit behavior directly in the domain of the sanction: the Iranian bank is laundering money illicitly and so identified and punished. As with the “racist” analogy, the mere act of voicing the label can have some impact, regardless of the factual basis underlying it. But, again keeping with the analogy, false claims can get exposed and if seen as a pattern, can quickly blowback against the sender. The new sanctions are best thought of as “conduct-based” – the taint sticks if, and only if, the designated entities actually are engaging in the illicit behavior. In theory, if the conduct improves the taint also might be eased; in practice it is a slow process.¹³⁶ It is near impossible to lift the taint if the behavior does not change. It is also very hard to impose the taint if there are no grounds for doing so.

¹³⁵ Zarate (2009), p.44.

¹³⁶ Following, and perhaps belaboring, the analogy, the racist label sticks if the individual really has engaged in racist conduct. The behavior triggers the label and the label, once legitimately imposed, is very hard to take off.

Given the bankers' primary concern about their profits, employing a politically based approach to dissuade them from continuing business transactions with illicit institutions would likely not prove effective; the banks are not going to stop doing business with an Iranian bank just because the Iranian regime is misbehaving elsewhere.¹³⁷ But if particular Iranian financial institutions are misbehaving – if there is direct illicit conduct – then other bankers will of their own accord steer clear of them. By illustrating the illicit nature of these firms, Treasury Department officials aimed to convince legitimate financial institutions that working with the firms represented a substantial business risk. Indeed, as relayed by senior Treasury Department officials, the sanctions did not target actions, "That the United States doesn't like politically, but conduct that's contrary to international law or international standards and norms."¹³⁸

The new sanctions thus target the bankers' business instincts, in the form of their risk calculi, rather than their political instincts. The sanctions target the risk calculi through two factors that our discussion has thus far conflated but that might alternatively or in tandem be at work: (i) a reputational logic and (ii) a functionalist logic. While they both might have the same ultimate effect, they work along analytically distinct causal pathways.

The Reputational Component to Influencing Bankers' Decisions

The reputational component of these coercive attempts focuses on legitimate financial institutions' concerns that conducting business with blacklisted firms will damage their overall public brands. In the Iranian case, as Stuart Levey noted in recent Congressional testimony, legitimate financial institutions' decisions to reduce their involvement with illicit firms, "Is a product of good corporate citizenship and a desire to protect their institutions' reputations. The end result is that the voluntary actions of the private sector amplify the effectiveness of government-imposed measures."¹³⁹ The logic underpinning this argument is that firms will be reluctant to deal with illicit firms simply because, in a post-9/11 era, being seen as willing to do business with firms that support terrorist organizations would lead to a negative branding and an associated decrease in business.¹⁴⁰ Indeed, as a senior governmental official put it, because a bank effectively sells its reputation, the threat of tarnish should have a significant effect on the bank's decision-making process.¹⁴¹

To create this reputational effect in the case of Iran, Treasury and State Department officials conducted a significant information campaign, meeting with senior banking officials in a number of European, Asian and Middle Eastern countries and presenting them with information detailing the illicit activities of their business partners. According to Treasury Department officials, this campaign involved tens of countries and over 40 banks.¹⁴² At these

¹³⁷ Interview with senior official.

¹³⁸ Bay Fang, "Treasury Wields Financial Sanctions; United States Strategy Straddles the Line Between Diplomacy, Military Might," *Chicago Tribune* 23 April 2007, p.C1.

¹³⁹ Stuart Levey, "Written Testimony before the Senate Foreign Relations Committee on 'Iran Policy in the Aftermath of U.N. Sanctions,'" U.S. Department of Treasury, TG-753, 22 June 2010.

¹⁴⁰ Interview with senior official.

¹⁴¹ Interview with senior official.

¹⁴² Jacobson (2008), p.72.

meetings, according to primary interviews, the bankers were informed about the financial institutions' direct relationships with the Iranian Revolutionary Guards Corps, an organization categorized as a terrorist group by the United States and an entity well-known for being involved in proliferation, ballistic missile and arms-smuggling activities. Indeed, as Secretary of the Treasury Henry Paulson phrased it, "It is increasingly likely that if you are doing business with Iran, you are somehow doing business with the Iranian Revolution Guards Corps (IRGC), a disturbing prospect given the important role this paramilitary organization plays in Iran's terrorism and proliferation activities."¹⁴³ The State Department worked closely with the banks' host governments in order to facilitate access for the Treasury Department officials.¹⁴⁴

Interestingly, the presentation of sensitive information linking the IRGC to different Iranian banks to non-U.S. companies presented a tricky task for senior government officials and required significant coordination both between the United States and its allies and partner countries, as well as between U.S. government bureaucracies. U.S. officials could not present extremely detailed information to these banks because of classification issues, and therefore these banks sometimes doubted the credibility of the information being shown.¹⁴⁵ As a result, U.S. officials adopted a four-track approach. First, intelligence community representatives would share, through intelligence channels, classified information to foreign governments at as sensitive a level as the protocols allowed. This created a "separate government endorsement" for subsequent information sharing.¹⁴⁶ Second, senior officials would present information to European and Asian financial institutions with allied governmental officials present to corroborate and supplement the information and generally provide credibility; the allied governments were persuaded by the previously shared intelligence information. Third, U.S. officials would directly present information to banks in foreign countries with whom

First, intelligence community representatives would share, through intelligence channels, classified information to foreign governments at as sensitive a level as the protocols allowed

they had long-standing, cooperative relations, such as the UK.¹⁴⁷ Finally, European and U.S. officials would present the information separately to the respective subsidiaries of each company depending on each country, e.g. the French would discuss the information with French firms whereas the United States would discuss the information with the U.S. subsidiaries of those firms.¹⁴⁸ These outreaches illustrated, according to one former senior official, one of the most important reasons these sanctions were able influence the decision-making of these bankers: the close-coordination of the diplomatic and financial strategy between the

Treasury and State Departments closed off possible escape routes for banks uninterested in severing their ties with the illicit firms.¹⁴⁹ By approaching host governments and showing them sensitive information regarding the illicit firms, U.S. government officials were able to prevent recalcitrant banks from using their host governments' position as an argument for not reducing their transactions with the illicit firms.

¹⁴³ Ibid, p.72.

¹⁴⁴ Interview with former senior official.

¹⁴⁵ Interview with former senior official.

¹⁴⁶ Interview with senior foreign government official.

¹⁴⁷ Interview with former senior official.

¹⁴⁸ Interview with senior official.

¹⁴⁹ Interview with former senior administration official.

Though for the purposes of this article we were unable to conduct interviews of these bankers to determine whether they perceived these reputational costs and acted on them accordingly, public statements by firms that did decrease their financial interactions with the target institutions suggest that reputation considerations did come into play. For example, in a press statement by a senior Credit Suisse officer regarding such a reduction, the reputational argument seems to have played a role: "It was our decision, made in the light of the increase in political, financial, and reputational risk."¹⁵⁰

The Functional Component to Influencing Bankers' Decisions

The Treasury Department has also pursued a more traditional path of attempting to influence bankers' decision-making by (a) making it more difficult to actually conduct the transactions, (b) suggesting the possibility of follow-on sanctions for other Iranian firms, and (c) severely punishing European and Asian financial institutions found to have violated Treasury's regulations. This pathway can be called "functional" since it operated directly on the core business function of the financial institutions, and the points of leverage were not an intangible reputation for dirty dealing but a tangible fine or other legal sanction.

The functional pathway was especially important given the dollar's role as a universal international reserve currency, and, in the case of Iran in particular, the dollar's role in the global oil market. Iran's primary industry is oil and international oil markets have been traditionally priced in dollars. Because foreign banks must convert assets into dollars in order to facilitate oil transactions, they must utilize the U.S. financial system directly, or interact directly with a source of dollars that has itself utilized the U.S. financial system. This contact makes them vulnerable to possible U.S. financial regulations and sanctions. Beginning in 2006, the United States began to utilize this reliance to create coercive leverage by banning "U-Turn transactions" with Iranian banks. U-Turn transactions permit companies to convert their financial activity into a common dollar denominator. For example, a U-turn transaction would permit "Iran to sell oil to a German customer, who in turn directs a European bank to deposit dollars obtained from an American bank into an Iranian bank account located in Europe. The phrase 'U-Turn' applies because the funds are transferred to a United States bank and instantly turned back as dollars to a European bank."¹⁵¹ An institution that cannot operate directly in the U.S. market and cannot do U-turn transactions is severely constrained from conducting commercial activity in any dollar-based market. By banning these types of transactions with Iranian banks, the Department was effectively able to freeze them out of conducting transactions in dollars. This had the follow-on effect of limiting European business with Iranian banks, as those banks could no longer receive dollar payments for their oil exports. According to Treasury analysts, this had an immediate impact on Iranian banks, which were heavily reliant on foreign oil sales in dollars and maintained as much as 20% of their foreign reserves in dollars.¹⁵²

¹⁵⁰ Mark Rice-Oxley, "U.S. Cautions Europe on Iran Investment," *Christian Science Monitor* 22 September 2006.

¹⁵¹ Steven Weisman, "U.S. Pursues Tactic of Financial Isolation," *New York Times* 16 October 2006.

¹⁵² Rachel Loeffler, "Bank Shots," *Foreign Affairs* (March/April 2009).

Treasury Department officials also conveyed implicit threats to deter continued business with both Iranian banks and other illicit-activity-supporting institutions. For example, during the Banco Delta Asia episode, U.S. officials first publicly highlighted BDA's role in North Korea's illicit activities. As Rachel Loeffler notes, this public notification resulted in decreased financial involvement, possibly due to the reputational concern associated with continuing to do business with the bank. At the same time however, it also raised the specter of possible future action taken against this bank by the United States because the Treasury Department indicated that it could cut BDA off from the U.S. financial system at any time. Thus, bankers were justified in avoiding continued business with BDA for fear that future sanctions would be levied that would jeopardize their business. Indeed, this concern was justified, as the U.S. made it illegal for American firms to conduct transactions with BDA in March 2007.¹⁵³ This threat of future sanctions was also conveyed, explicitly or implicitly, in the meetings between Treasury Department officials and bankers. For example, "One of the main unspoken messages [of these visits] is that the United States government may eventually bar American banks from working with the financial institutions doing business with groups tied to terrorism."¹⁵⁴ Senior U.S. government officials agreed with this assessment, suggesting that though they might not have told the bankers' that future sanctions were coming, the very fact that senior American officials were flying to meet many of them conveyed the gravity of the situation and suggested that the U.S. government was actively considering escalation.¹⁵⁵ Further, the U.S. government went so far as to explicitly threaten future punishment; in 2007, Stuart Levey asserted that, "And those who might still be tempted to work with targeted high risk actors get the message loud and clear: if they do so, they may be next."¹⁵⁶

The United States has also shown a willingness to follow through on this threat, severely punishing firms that do not comply with its regulations barring business with illicit institutions. For example, in January of 2009, the Treasury Department fined Lloyds of London \$350 million after uncovering that the firm had, "Between 1995 and 2007, routinely removed customer names, bank names [of Iranian and Sudanese firms] and addresses from payments so that wire transfers would pass undetected through filters at US institutions."¹⁵⁷ Lloyds was not the only bank to suffer for continuing to do business with illicit firms however; Credit Suisse engaged in a similar deception, hiding the names of its Libyan and Iranian business partners in an attempt to avoid U.S. financial punishment and was fined as a result.¹⁵⁸ ABN Amro, the Dutch bank, was also fined \$80 million dollars by the United States for failure to bring its practices vis a vis Iran and Libya in line with Treasury Department regulations.¹⁵⁹ Beyond these cases, Riggs Bank and UBS were found to have conducted financial transactions with Iranian firms contravening either recent or more historical Treasury regulations meant to prohibit financial relationships with Iranian, Libyan and Sudanese institutions.¹⁶⁰

153 Ibid.

154 Weisman (2006).

155 Interviews with senior and former senior officials.

156 Stuart Levey, "Testimony Before the Senate Committee on Banking, Housing and Urban Affairs," U.S. Department of Treasury HP-325, 21 March 2007.

157 Andrew Clark, "Lloyds forfeits \$350m for disguising origin of funds from Iran and Sudan: Record payout for breach of US financial sanctions Bank says payout relates to 'historic practices,'" *The Guardian* 10 January 2009.

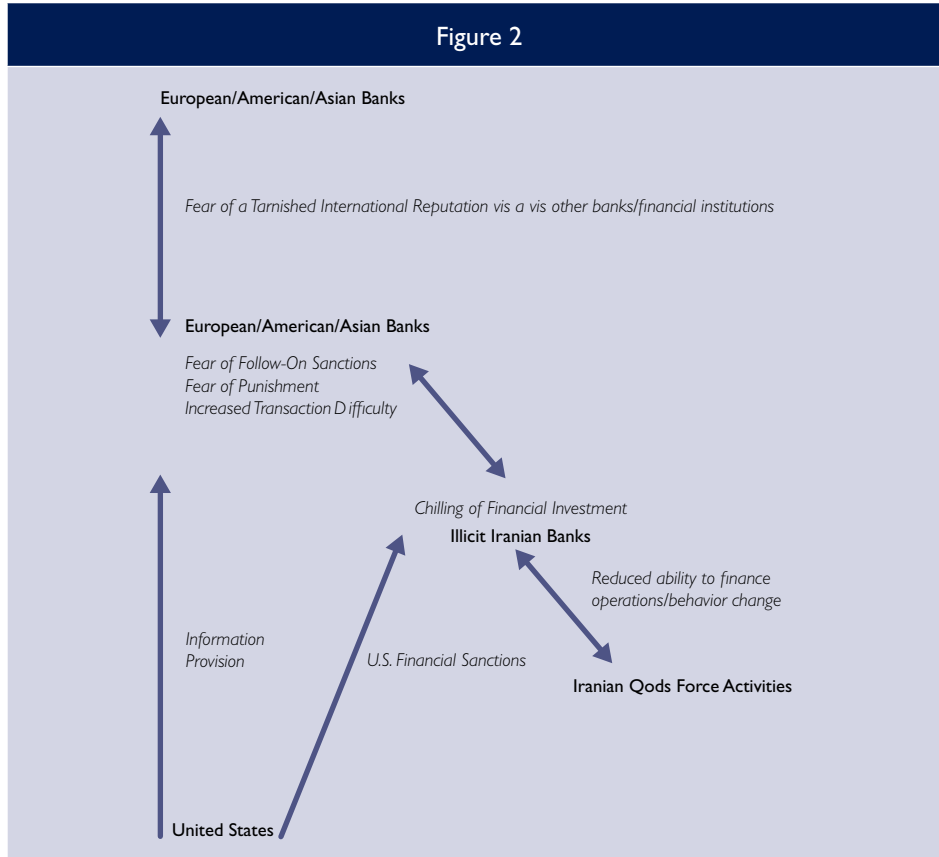
158 "Settlement Agreement Between the Office of Foreign Asset Control and Credit Suisse AG," U.S. Department of Treasury, MUL-473923, 16 December 2009.

159 Stephanie Kirschgaesner, "Banks Braced for Fines," *Financial Times* 29 August 2007.

160 Zarate (2009), p.46.

Are the Components Analytically Distinct?

These two basic logics – the reputational and the functional logic – could in theory work separately (see Figure #2 for a visual representation). Some financial institutions may be concerned about reputation but insensitive to functional threats, or vice-versa.



In practice, they probably operate in tandem and their separate, independent impact may be impossible to tease out – even for those bankers making the decisions. Though difficult to determine without access to the bankers, interviews with both U.S. and foreign government officials suggest that it was a combination of the two. For example, senior officials suggested that the information provision meetings with European bankers clearly signaled seriousness on the part of the U.S. government and suggested that future sanctions were quite possible. As one official put it, “These bankers were smart guys, they understood that if we were flying all the way over there and making such a big deal about what was being said, the possibility existed in the future for follow-on penalties and sanctions.”¹⁶¹ According to unnamed foreign government officials, certain European bankers feared being shut out of the U.S. market more than any possible reputational tarnish that might develop from continuing business with these illicit firms.¹⁶² At the same time however, these bankers did, in both public statements and to Treasury Department officials, suggest that reputation concerns played a role in their decisions. As a result, though it is impossible to determine how much weight these concerns carried, they do appear, working in conjunction with fears of follow on-sanctions and punishment, to have had played some role in influencing bankers’ decisions.

¹⁶¹ Interview with former senior official.

¹⁶² Interview with foreign senior official.

CHAPTER 4

THE EFFECT ON THE TARGET: THE SPREAD OF PAIN, THE QUEST FOR ESCAPE, AND THE CHANGE IN BEHAVIOR

In terms of their impact on the target, the new sanctions differ from the old sanctions in one significant respect: in theory, the new sanctions should have a ratchet effect whereby over time they become ever more painful. First, the reputational effect should steadily migrate across the financial system and gradually raise the costs of doing business with and inside the target's economy. As more and more access points to the global financial system are closed, the pain should increase. Moreover, attempts to get around these constraints should – if detected – themselves suffer the same taint and thus expand the zone of forbidden, or at least constrained, activity. Like the proverbial Chinese finger trap, which gradually tightens as the victim struggles to escape, these new financial sanctions should in theory tighten inexorably around the target. In practice, the new sanctions have shown some of the same limitations as old sanctions, with resourceful targets showing some ability to develop work-arounds. For example, following the sanctioning of Bank Sepah and Melli, the Iranians began to rely on Bank Post to conduct similar types of activities.¹⁶³ In shipping, the Iranians have also re-named many of their ships and front companies, allowing them to continue operation.¹⁶⁴ Of course, once discovered these new institutions can themselves be designated and the same sanctioning effect begun anew (provided that the conduct-based threshold of proof can be met). What this means is that in practice, the new sanctions have something of the same interactive measures/counter-measures dynamic that old sanctions have: the sender initiates the pain, the target wiggles enough to reduce the pain, the sender responds by tightening the grip, and so on. In other words, the new sanctions may not be quite as automatic and inexorable as a Chinese finger trap.

¹⁶³ Stuart Levey, "Remarks on Designations Targeting Iran's Nuclear and Missile Programs," U.S. Department of Treasury, TG-746, 16 June 2010.

¹⁶⁴ Stuart Levey, "Remarks on Designations Targeting Iran's Nuclear and Missile Programs," U.S. Department of Treasury, TG-746, 16 June 2010. See also Jo Becker, "Web of Shell Companies Veils Trade by Iran's Ships," *New York Times* 7 June 2010.

Of course, at the next stage in the coercion chain, the new and traditional sanctions share exactly the same causal logic: in theory, the pain imposed on the target should reach a point where the target prefers to comply so as to lift the pain. We have not reached this stage in the real world, but in theory it is attainable. The new sanctions have imposed significant pain on their targets – arguably more pain than the traditional sanctions have been imposing in recent years – and the target regimes in Iran and in North Korea are undeniably under considerable strain.

In the Iranian case, significant numbers of banks and firms have reduced their business relationships with Iran following the issuance of these new sanctions.¹⁶⁵ For example, BNP Paribas and Credit Agricole stopped offering lines of credit to Iranian banks upon being visited by the United States and its French counterparts.¹⁶⁶ Credit Suisse began a ‘controlled withdrawal’ from dealings with refusing to begin new business and UBS cut off existing projects it had already undertaken in early 2006.¹⁶⁷ This chilling has had a significant impact on the economic relationship between Iran and the European financial world. Prior to the issuance of these sanctions, bilateral trade between the European Union and Iran in 2006 was approximately \$25 billion, financed primarily through these Iranian state-owned banks and their European counterparts.¹⁶⁸ Following U.S. discussions with these banks, however, a significant decline occurred in the number and size of export credits these banks were willing to issue (and the number and size of credit guarantees the European governments have been willing to back). This has had direct effects on the levels of trade between the EU and Iran. For example, German officials suggest a 20% reduction in exports from German firms to Iran because of their concern of doing business with illicit actors.¹⁶⁹ Indeed, this concern has reportedly led to a decline of over \$5 billion in exports from EU states to Iran from 2005-2006.¹⁷⁰ It also has led to an increased cost of business for Iranian businesses, with some suggesting that it places a 10-30% premium on securing financing.¹⁷¹

More recently, these sanctions have helped stall the development of Iran’s South Pars natural gas field, at one time projected to bring in over \$130 billion annually in revenue to the economically troubled country: Halliburton, Shell, and Total have pulled out of the project for fear of running afoul of sanctions.¹⁷² While Chinese firms have moved in to develop the field, Iranian officials acknowledge that the pullback by Western firms represents a serious blow to the pace and quality of development.¹⁷³

165 These banks included: BNP Paribas, Credit Agricole, Credit Suisse, UBS, HSBC, Deutschebank, Dresdner Bank, Commerzbank, Standard Chartered, Lloyds, Natexis, Banques Populaires, ING, SG Corporate and Investment Banking, EXIM, and Barclays. For a comprehensive visual representation of the different types of sanctions levied against Iran, including some of their effects, see Roula Khalaf, Najmeh Bozorgmehr, Daniel Dombey, James Blitz, and Carola Hoyos, “Are Iran Nuclear Sanctions Working?” *Financial Times* 12 July 2010.

166 HSBC representatives, for example, said that, as a result of new U.S. sanctions, “That no dollar transactions were being conducted for Iranian clients and business links with Teheran were now minimal.” David Blair, “Banks Recruited to Wage Financial War on Teheran,” *The Daily Telegraph* 18 September 2007, p.17.

167 Weisman (2006).

168 Simon Tisdall, “Meddling With Money Pays Dividends,” *Guardian International* 13 February 2007, p.17.

169 Ibid.

170 Jacobson (2008), p.74. Concerns about Iranian actions have also caused European governments to scale back, though this is likely more of a political maneuver than as a result of any reputational concern. For example, Germany’s Economic Ministry has scaled back export credit guarantees it issues for trade with Iran, to \$1.2 billion in 2006 from \$3.3 billion in 2004. Mark Landler, “Germany’s Commercial Ties with Iran Prove Hard to Cut,” *New York Times* 21 September 2007, p.7.

171 Roula Khalaf, Najmeh Bozorgmehr, Daniel Dombey, James Blitz, and Carola Hoyos, “Are Iran Nuclear Sanctions Working?” *Financial Times* 12 July 2010.

172 Thomas Erdbrink, “Sanctions Slow Development of Huge Natural Gas Field in Iran,” *Washington Post* 23 July 2010.

173 Thomas Erdbrink, “Sanctions Slow Development of Huge Natural Gas Field in Iran,” *Washington Post* 23 July 2010. See also Stuart Levey, Congressional Testimony, Senate Foreign Relations Committee 22 June 2010.

Concerns about conducting business with Iranian firms has led to chilling in financial relationships outside of Europe as well; banks in the United Arab Emirates – a historical transit point for goods from Europe and Asia to Iran and a country often accused of helping Iran launder money and ship illicit materials – are also increasing the financial costs for Iranian companies. For example, in Dubai, many firms have stopped offering lines of credit to these illicit Iranian banks, making it difficult for them to find financing for any goods, not just potentially illicit ones.¹⁷⁴ In Bahrain as well, the Ahli United Bank suspended all business with Iran in January 2008 for fear of being reputational contamination; Ahli United, which had established a joint project, “Future Bank,” with Iranian banks Saderat and Melli (two of the banks which were sanctioned), assessed that continuing the partnership was highly risky given concerns about the possibility of the U.S. sanctioning Future Bank because of its ties with Saderat and Melli.¹⁷⁵

This economic slowdown has certainly caused Iran economic pain; for example, as Hamid Borhan, the chairman of Bank Saderat (one of the targeted Iranian banks) suggested, profits from foreign operations were down 30% for 2006 when they likely would have been much higher absent the sanctions.¹⁷⁶ More recent assessments corroborate this story; in the oil and natural gas industry, Iranian officials have complained that these sanctions have hurt their ability to purchase the capital equipment necessary for modernization of their largest economic sector.¹⁷⁷ Partially as a result, Iranian oil production has decreased from 4.1 million barrels a day in 2005-06 to 3.5 million barrels a day in 2009-10 and their

profits from oil exports have leveled off at around \$80 billion annually despite a continual increase in the price of crude oil.¹⁷⁸

Foreign direct investment (FDI) has also slowed significantly into the country, falling from a high of approximately \$3 billion in 2005 to less than \$1.5 billion in 2008.¹⁷⁹

In theory, this pain might change their internal political calculus enough to consider cutting a deal with their tormentors, namely the United States and the world community. In practice it has not, yet this does not mean the sanctions have been completely unsuccessful, as there is some indication that the sanctions are meeting the expectations hoped for by U.S. officials. These senior officials believed that though these sanctions might be powerful, they would not independently create sufficient pain to cause Iran from proceeding down the nuclear path.¹⁸⁰ Rather, the sanctions were meant to do two things: first, to create a conversation among the Iranian elites that continued non-cooperative behavior on the nuclear issue would increase their international isolation and that Iran would be viewed increasingly as outside of

Foreign direct investment (FDI) has also slowed significantly into the country, falling from a high of approximately \$3 billion in 2005 to less than \$1.5 billion in 2008

174 Roula Khalaf, Simeon Kerr; and Daniel Dombey, “Dubai Reacts to U.S. Pressure on Iran,” *Financial Times* 20 December 2007.

175 Mark Trevelyan, “More Companies Suspend Business with Iran,” *International Herald Tribune* 17 January 2008, p.15.

176 Katrina Robinson, “Iran – Investment Opportunities Amid Political Risk – Foreign Banks Are Finding The Lure of Iran’s Large Population, Oil-Rich Heritage, and Privatisation Opportunities May Outweigh Risks,” *The Banker* 1 July 2007.

177 Erdbrink (2010).

178 Khalaf et al. (2010).

179 Ibid.

180 Interview with senior officials. See also Stuart Levey, “Minimizing Potential Threats from Iran: Administration Perspectives on Economic Sanctions and Other United States Policy Options,” *Testimony delivered before the Senate Committee on Banking, Housing, and Urban Affairs*, 6 October 2009.

the international community.¹⁸¹ Direct evidence of these debates is difficult to come by, however classified data suggests that the sanctions have created a high degree of concern among the Iranian leadership because of their likely economic effects.¹⁸² Moreover, the economic hardships, created in part by these sanctions, have begun to cause political unrest in the country; large governmental tax increases, due in part to dwindling government revenues as a result of these sanctions, have caused significant numbers of Iranian Bazaaris to strike and conduct protests.¹⁸³

Second, these officials had another purpose in issuing these sanctions: capability reduction. As stated by senior government officials, reducing the ability of the Iranian banks to finance illicit activities such as the purchase of centrifuge or ballistic missile technology has been one of the primary goals of the sanction imposition.¹⁸⁴ By this metric, the sanctions have likely been more successful, as the costs for financing have risen significantly, making it more costly to acquire legitimate goods, capital equipment, and services.

These two effects are key to the U.S. coercive strategy; The purpose of the sanctions was, using a combination of sticks and carrots (e.g. access to international fuel, ascension in the World Trade Organization, etc.) to convince the Iranians that any deal they would strike now would be better than one they could achieve in the future. Indeed, the necessary-but-not-sufficient condition for diplomatic success is for the Iranian regime to believe they are on a negative trajectory. The longer the delay, the worse things would get for them. By slowing down their economic growth and preventing the progress of their nuclear and ballistic missile programs through sanctions, the United States is attempting to do just that. Despite these positive indications that the sanctions are having some bite and achieving their objectives, it is still unclear whether they will significantly alter Iranian behavior in such a way that causes them to abandon their nuclear program.¹⁸⁵

Since we have not yet reached the capitulation stage in the real world, we do not know how in practice the new sanctions would work for the final stage of the coercion chain, but we know in theory precisely how it is supposed to work: once capitulated, the target is supposed to be rewarded with the relief of the pain. Here there is cause to speculate that the new sanctions might operate along a different, and unintended pathway. Since traditional sanctions are triggered by the larger offending political behavior (e.g. taking hostages, pursuing WMD, conducting terrorism), a diplomatic deal that changes this larger political behavior should trigger a release of the sanctions. Even perceived but incomplete progress towards a diplomatic deal could be rewarded by an easing up of the sanctions – for example, see the twists and turns of the international communities efforts to coax and cajole Saddam Hussein in the 1990s. But the new sanctions are conduct based and, in particular, historical conduct based. Once having triggered the designation, the bank is by definition tainted; an improvement of the regime's behavior in other domains should not be sufficient to remove the original taint, at least insofar as that particular institution is concerned.

181 Interview with senior official.

182 Stuart Levey, Congressional Testimony, Senate Foreign Relations Committee 22 June 2010.

183 Gerald Seib, "Watching for Ripple Effects as Sanctions Nip at Iran," Wall Street Journal 23 July 2010.

184 Interview with senior official.

185 President Barack Obama made a similar point in a recent meeting with members of the press, suggesting that no amount of economic pain coupled with diplomatic incentives may be sufficient to deter the Iranians from pursuing a nuclear capability. See David Ignatius, "Signals from the Briefer in Chief," Washington Post 5 August 2010.

Moreover, since the reputational effect spreads via the private sector which the government influences but doesn't control, the new sanctions may not be able to be relaxed slightly as a way of rewarding partial diplomatic progress. The North Korea case discussed below provides a vivid illustration of this potential problem.

This analysis of the later stages of the coercion chain is necessarily speculative since the new sanctions have not been in operation long enough to provide historical data. But if accurate, this speculation could significantly alter the overall utility of these sanctions – which brings us to an evaluation of the pros and cons of these new sanctions.

Limits and Unintended Consequences

We have already seen that, like many other types of sanctions, these mechanisms of coercive diplomacy have real limits as to what they can achieve; for example, it is unrealistic to expect them to independently cause a state to begin acting against its core national interests because the amount of pressure they can bring to bear is simply insufficient. Yet these sanctions also suffer from hitherto underappreciated limits that may further reduce their effectiveness as tools of diplomacy.

Most broadly, the power of these sanctions is also their Achilles' heel: reliance on the private sector. Because these sanctions leverage the concerns of businesses, they are also subject to the changing cost-benefit calculations of those businesses. If global business conditions change, the firms might re-calculate that engaging in financial transactions with those targeted states outweighs the costs. This dynamic is most visible in the Iran case, where the size of the Iranian market has proven to be a strong lure, even for U.S. firms. For example, in a series of recent news reports and articles, law professors and reporters have noted that U.S. firms, including such well-known businesses as Halliburton, continue to use foreign subsidiaries to invest directly in Iran's oil industry, despite U.S. laws prohibiting such investments by the U.S. parent companies themselves. According to law professor Amy Westbrook, U.S. firms are able to raise money in U.S. capital markets and then incorporate a subsidiary in a foreign country that does not impose sanctions against Iran. The U.S. firm can then finance the subsidiary's direct activities with the targeted country.¹⁸⁶ Indeed, the Iranians are well-aware of the desire of both American and European firms to continue to do business in Iran's large and developing markets, and as a result have adjusted their strategies to target these institutions' bottom lines as well; according to Deutchesbank and Commerzbank officials, the Iranians threatened both firms that if they pulled out as a result of U.S. sanctions and pressure, the Iranians would not allow the firms to re-enter the Iranian market upon the return of less tumultuous circumstances. As seen in the Iranian case, however, ways do exist to mitigate these profit-seeking activities. In particular, close coordination between key bureaucracies provided a key element in pressuring banks to suspend their transactions by closing off possible escape routes. This coordination is both a boon and a limit however; in circumstances where it is lacking or difficult to achieve, the sanctions will be all the more difficult to implement.

¹⁸⁶ Amy Westbrook, "What's in Your Portfolio? Investors Are Unknowingly Financing State Sponsors of Terrorism," *DePaul Law Review* Vol.59, No.4 (Spring 2010), p.5. See also Rebecca Leung, "Doing Business with the Enemy: Are U.S. Firms Doing Business in Nations that Support Terrorism?" 60 Minutes 24 August 2004.

These sanctions can also create perverse incentives for financial firms to cheat and surreptitiously invest in the country. As seen in the cases of Lloyds and Credit Suisse, analysts and financiers actively knew that they were facilitating illicit transactions, including the 'stripping' of monies (which involves stripping the identity of the dollars' origins and destinations to allow for processing through U.S. banks).¹⁸⁷ Indeed, these transactions occurred for many years despite strict prohibitions against such activity, suggesting that it was both understood to be illegal yet still a profitable approach to doing business on the part of these firms.¹⁸⁸ Increased financial sanctions, while making it more difficult to avoid prosecution if found out, also make the rewards of illegally doing business in Iran more lucrative, as there are fewer competitors (because the sanctions have deterred other bankers) to drive down prices. In this sense, depending on the strength of the enforcement mechanism, these sanctions may be 'self-busting.' Indeed, this is a problem with any economic sanction, but it is especially acute with a sanction whose causal mechanism rests so heavily on business self-interests: sanctions simultaneously impose costs on law-abiders and create rewards, albeit risky rewards, for those who would cheat. In the Iranian case, there are plenty of non-Western firms willing to step into the vacuum left by the reduction of investment by Western banks and investment firms. A number of Chinese firms, for example, have used this gap to secure lucrative oil contracts for which they would not normally be competitive.¹⁸⁹

Relying on private firms' business concerns also creates problems in ways not previously seen with other types of sanctions

Relying on private firms' business concerns also creates problems in ways not previously seen with other types of sanctions. First, because these types of sanctions may be 'sticky,' they can lead to a serious disconnect between the diplomatic track and the business track that can sabotage attempts to achieve political outcomes. This problem might arise because the sanctions rely on identifying and utilizing 'conduct-based behavior' to achieve their coercive leverage. As discussed, when banks are informed that their business partners are engaged in illicit activities, this creates a substantial incentive for them to cease doing business with that firm. By this same logic however, to convince bankers that the illicit firm will no longer be the target of sanctions and no longer represents a reputational risk, the illicit firm must change its conduct. Absent this change, the Western firms may well continue to avoid doing business with it for fear of reputational and sanction-induced penalty. In this sense, the sanctions might be 'sticky' because merely lifting the sanction might not necessarily reduce its effect – banks could still be concerned about the conduct of these illicit firms even after official sanctions are no longer levied against them.¹⁹⁰

The problem is that this can create substantial difficulties for the United States in trying to use the private sector response to create coercive leverage. As discussed

187 Andrew Clark, "Lloyd's Forfeits \$350 Million for Disguising Origin of Funds from Iran and Sudan," *The Guardian* 10 January 2009.

188 "Settlement Agreement between the U.S. Department of Treasury's Office of Foreign Asset Control and Credit Suisse A.G.," MUL 473923, 16 December 2009.

189 Stuart Levey, Congressional Testimony, Senate Foreign Relations Committee 22 June 2010. See also Thomas Erdbrink, "Sanctions Slow Development of Huge Natural Gas Field in Iran," *Washington Post* 23 July 2010.

190 Some senior U.S. officials disagree on this point, arguing that if the United Nations, for example, lifted sanctions against particular Iranian firms, because of their desire to return to the Iranian market, European and American banks would quickly increase their business operations in the country. Interview with senior official.

previously, one of the key operating principles of coercive diplomacy is the ability to lift the sanction in exchange for an adjustment in the target state behavior; indeed, every sanction that is issued with a demand is also an implicit promise – change your negative behavior and the punishment will no longer apply. But the United States cannot control the response of the private actors who have judged, as a result of the behavior of the illicit firm, that conducting such business is risky. Thus the United States cannot fulfill the promise in exchange for a shift in target-state behavior, and the entire coercive diplomacy strategy is undermined.

Second, these types of sanctions may have diminishing marginal returns for achieving diplomatic outcomes in a double-sense. On the one hand, ratcheting up the sanctions becomes difficult precisely because their initial implementation can have such a powerful effect. For example, in the North Korean case, targeting Banco Delta Asia led to a massive reduction in firms conducting business with the bank and this arguably played a significant role in bringing the North Koreans back to the bargaining table. Yet, even when the sanctions were lifted on BDA and the money was returned, financial firms refused to reinvest with the bank. While showing the power and institutional memory of the financial industry, this episode also illustrates a significant limit of these sanctions: they may be very effective for single-shot usage but lose their utility over time. Because firms did not reinvest in BDA, the United States could no longer expect to use it to create coercive leverage for diplomatic purposes, as sanctioning it would no longer have an effect. This decreasing

marginal utility may also hold when examining the Iranian case.

For example, by tarring Iranian financial firms, the United States has significantly reduced the incentives of investment by Western firms in the country. Yet, as mentioned by senior officials, this is a double-edged sword; while it increases pressure on the Iranian regime, it also decreases the severity of possible future sanctions: because many firms have already reduced investment into the country, future sanctions likely will not have as much bite.¹⁹¹ Indeed, if the current round of sanctions does not lead to a sufficiently desirable solution for the United States, it seems that, given this dynamic of diminishing marginal utility, follow-on sanctions of similar ilk will be even less-likely to prove effective.

On the other hand and returning to this issue of the divide between economics and politics, continued utilization of these types of sanctions may undermine their future effectiveness and U.S. economic competitiveness more generally. By continuing to leverage financial power for political ends, the United States risks alienating firms that would otherwise be willing to conduct transactions in dollars or operate more widely in the U.S. market. This possible perverse consequence becomes most visible with the United States' unique ability to leverage the dollar-based international oil market and bankers' responses to this exercise of power. According to senior officials, some of whom have worked for the Western financial firms concerned about continued operations in

This use of economic leverage for political means catalyzed a number of debates among the bankers as to whether, in the future, they should continue to rely heavily on U.S. currency if their profits were going to be subject to U.S. political whims

¹⁹¹ Interview with senior official.

Iran, when the United States began closing off its financial sector to transactions involving Iran to European banks, this caused a significant degree of consternation among those bankers.¹⁹² These bankers saw it as a direct attempt by the United States to utilize its financial power (in the form of significant control over the international oil market because its standard currency is the dollar) to achieve particular political goals; indeed, in a way not dissimilar from what these types of sanctions were originally designed to avoid, the bankers were frustrated that their business investments and bottom lines were being jeopardized for U.S. political ends. This use of economic leverage for political means catalyzed a number of debates among the bankers as to whether, in the future, they should continue to rely heavily on U.S. currency if their profits were going to be subject to U.S. political whims.¹⁹³ While not necessarily leading to an immediate decrease in the efficacy of these sanctions, this frustration on the part of the bankers is suggestive of two possible inherent limits to their continued use. The first is that, if the United States continues to use its financial system to serve explicitly political goals, this may deter future investment and spawn a degree of backlash where firms push to conduct transactions in alternate currencies and through alternate banking centers. This may have a direct effect on U.S. economic competitiveness. Second, and following from bankers' reluctance to continue conducting transactions in dollars for fear of being subject to political whims, it may be more difficult to give these sanctions 'bite' over time. If it is the case that firms are reducing their transactions in dollars and their involvement in the U.S. financial system more generally to avoid these types of penalties, this also means that U.S. attempts to utilize this system to achieve political ends will similarly be reduced. While both of these concerns seem relatively abstract in that no substantial evidence suggests firms have already begun reducing their transactions with U.S. companies or through the U.S. financial system because of this issue, senior Treasury Department officials are aware – and concerned about – this possibility.¹⁹⁴

Like traditional sanctions, targeted financial sanctions can also accidentally damage actors not responsible – or able to change – the misbehavior of the targeted country. In this case however, this collateral damage often involves 'innocent' firms, not innocent civilians. For example, according to senior Bush administration officials, following the success of these sanctions in North Korea and Iran, the United States began considering their use against Russian banks and other institutions in Abkhazia and South Ossetia during the summer 2008 Russian-Georgia war. The purpose of employing these sanctions would have been to target financial firms in the breakaway provinces engaging in possible illicit activities and use the possibility of lifting those sanctions to convince the Russians to cease military operations.¹⁹⁵ Administration officials even went so far as to draft an executive resolution that would have gone after these institutions and any firm providing

Because firms did not reinvest in BDA, the United States could no longer expect to use it to create coercive leverage for diplomatic purposes, as sanctioning it would no longer have an effect

¹⁹² Interview with senior official.

¹⁹³ Interview with senior official.

¹⁹⁴ Interview with senior official.

¹⁹⁵ Interviews with former senior officials.

material support to the breakaway provinces.¹⁹⁶ When analysis was done of the possible effects of these sanctions however, it quickly became apparent that their implementation would also significantly damage prominent U.S. firms who were financially involved with the Russian businesses.¹⁹⁷ In response to this possibility, administration officials decided not to employ these coercive measures. Though we do not know of significant numbers of analogous anecdotes, in this way these new types of sanctions may suffer from similar limitations regarding collateral damage.

Perhaps the most constraining element of these new sanctions is simply their reliance on illicit conduct by the target. As the sanctions derive their power from the decisions of the private sector to reduce investment due to illicit activity, absent that activity they will be ineffective. Indeed, as many in Treasury have noted, bankers and financiers will not simply cut off transactions with these firms to help the United States achieve particular political goals. This requirement was not an obvious fact for many within the Bush and Obama administrations, as many senior officials approached Treasury Department staff requesting the implementation of these new sanctions against targets not engaged in illicit activities.¹⁹⁸

Assessment: How Do These Sanctions Stack Up Against Other Types?

In comparison to comprehensive and older forms of targeted sanctions, financial mechanisms do appear to be more effective and efficient. Like comprehensive sanctions, they can transmit a great amount of pain, both to the elites and to the broad population via the general reduction in economic activity that comes with decreased financing and interaction in the international business sector. Yet unlike comprehensive sanctions, they may not be overly difficult to impose, as the United States has been able to apply elements of them unilaterally. Likewise, because they both rely on the incentives of the private sector for the creation of coercive leverage and the U.S. government has been vigilant in enforcement, they may decrease the likelihood that the target can successfully evade them. Indeed, in sharp contrast to the cheating rampant with oil sanctions levied against Iraq in the 1990s, few firms have engaged in illicit transactions with Iran, those that have and been caught have been fined heavily, and Iran's attempts to circumvent the sanctions have been consistently identified and stopped.

They also avoid one of the primary pitfalls of targeted sanctions: the ability to create sufficient leverage to change a target's calculus. Targeted sanctions, while avoiding the creation of pain on the general population, often times only focus on elite vulnerabilities that are not vital to the target, such as bans on flights, luxury items, and arms imports. While no doubt important in some cases, elites can often circumvent these restrictions by taxing their populations more heavily to acquire the same goods or substitutes. In contrast, these new sanctions are able to create leveraged effects by convincing large swaths of

¹⁹⁶ Interview with former senior official.

¹⁹⁷ Interview with former senior official.

¹⁹⁸ Interview with senior official.

the private sector to reduce their financial involvement with the target. Moreover, at least in the Iranian case, these new sanctions are targeted on key regime pressure points; by focusing on IRGC-controlled financial institutions, the coercive leverage can effectively be directed against targets of the highest value to the Iranian elites.

In fact, these new coercive mechanisms coincide fairly closely with the ideal conception of sanctions. In addition to other elements mentioned above, they impose more costs on the target than the sender, as the cutoff from the international financial community is far more painful for Iran than the lack of business with that country is for the United States. They are also easier for allies to support than traditional sanctions; whether or not they agree with the overall political goals of the sender, the allies still do not want their countries' firms to suffer the taint of doing business with illicit actors or engaging in activities that support terrorism. And arguably, the pain of these sanctions increases over time; as financial institutions begin to reduce involvement for fear of their reputations being tarred, this, according to Treasury Department officials, has served as a signal to other firms that they should also reduce their business in the target country.¹⁹⁹

Despite their advantages however, there are inherent downsides to these sanctions not experienced by more traditional forms. Stemming from the experience sanctioning North Korea, it is clear that these sanctions suffer from a possible disconnect between the coercive leverage employed and the political strategy. In particular, the targeted institution must cease its illicit activity before the coercive pressure on the target state can be lifted. Barring this action, even if there is a diplomatic desire to strike a deal with the target state, it may be surprisingly difficult to lift the pressure. Even if the target institution stops the illicit activity, reputational concerns about doing business with an institution so recently engaged in illicit activity will prevent many private firms from re-starting their business relationships.

Another possible downside (and current unknown) is the effect of these sanctions on innocents. As mentioned by current senior officials working closely in this area, one of the primary reasons for not targeting more banks within Iran is that sanctions applied to entities such as the central bank run the risk of severely damaging the entire Iranian economy and causing great damage to civilian populations.²⁰⁰ It is unclear whether these financial sanctions are sufficiently targetable to avoid causing major economic problems that affect innocent actors (and therefore, like in the Iraqi case, undermine the entire sanctions regime).

Perhaps more limiting than any of these factors is the broader context in which these sanctions can operate; while they can be effective, their range of effectiveness is narrower than other types of sanctions. In order to have any bite, they require illicit conduct that is identifiable by the sender state. Without this key element, the sender cannot utilize the power of the private sector to create leveraged pressure. This is a key differentiating element from comprehensive and targeted sanctions; because these sanctions rely on illicit conduct, not necessarily political activities of the target, they cannot be used in nearly as many circumstances. Indeed, it is quite possible that other states will learn from the very

¹⁹⁹ Stuart Levey, Congressional Testimony, Senate Foreign Relations Committee 22 June 2010.

²⁰⁰ Interviews with senior and former senior officials.

public experiences of Iran and North Korea and reduce the illicit conduct of their firms to avoid this type of coercive pressure in the future. Thus, while their downsides appear to be less significant than those associated with more traditional types of sanctions, their upsides may be more circumscribed to a smaller number of cases as well.

Figure 2		
	Pros	Cons
Ideal Sanctions	<ul style="list-style-type: none"> – Imposes Significantly More Costs on Target Than Sender – Difficult to Work Around for Target – Easy for Allies to Support – Pain Inflicted Increases Over Time – Pain is Focused on Decisionmakers and the Selectorate – Pain is Focused on Items the Selectorate Values 	
Comprehensive Sanctions	<ul style="list-style-type: none"> – Can involve great pain 	<ul style="list-style-type: none"> – Difficult to Impose – Difficult to Sustain (Civilians) – Ethical concerns – Easy to Circumvent
Targeted Sanctions	<ul style="list-style-type: none"> – More Direct Pressure on Elites – Less Collateral Damage – More Sustainable 	<ul style="list-style-type: none"> – Decreasing Utility Over Time (Enemy Learning) – Limited Leverage
Financial Reputational Sanctions	<ul style="list-style-type: none"> – Leveraged Effects – Directly Targets Illicit Action – Able to be Imposed Unilaterally 	<ul style="list-style-type: none"> – Create Perverse Incentives for Private Sector Cheating – Disconnect between Sanction and Diplomatic Strategies – Diminishing Marginal Utility – Useful in Narrow Circumstances

CONCLUSION

In sum, these sanctions are an interesting and important addition to the theory and practice of coercive diplomacy. On the analytic ledger, given that these sanctions do appear to have some degree of effect on the target, they indicate that reputational concerns of non-security entities (i.e. business firms) can affect issues of 'high' politics such as state security. This stands alongside and corroborates recent research in the field, such as that of Cochran and Sechser, suggesting that under certain conditions, reputation can be quite important in determining outcomes of international conflicts and disputes. Likewise, this research also suggests an interesting – and heretofore under-explored – area of research in economic sanctions and coercive diplomacy more broadly: the role of the private sector. Though recently scholars have begun to examine the privatization of the military, few have conducted serious analyses of how private firms have influenced – positively or negatively – the employment of coercive diplomacy. As discussed by senior Treasury Department officials, given the ability to influence a country's economy through the private sector, this field is ripe for further exploration.

On the policymaking side, this analysis suggests that while it is too early to know whether they can be effective in changing a target-state's behavior, they appear to be able to cause the target significant pain. However, while they may be quite useful in a limited number of circumstances, they will not necessarily trump other types of coercive diplomacy and – like alternate forms of sanctions – will need to be used in conjunction with other tools of statecraft. Moreover, because they require illicit conduct on the part of the target to be effective, policymakers must recognize that they cannot be utilized in a large number of circumstances (and therefore policymakers should not believe that the prospects of coercive diplomacy success are greater than they actually are). Policymakers should also utilize caution for at least three other reasons: first, some of their effects are uncertain. Though it does not appear that they have caused significant damage to civilian targets in the two cases in which they have been employed, it is possible that, if targeted at certain financial institutions such as central banks, they could wreck entire economies. Such events would, like with comprehensive sanctions in the 1990s, significantly dissuade policymakers from using them in the future despite possibly high prospects for success. Second, these sanctions can often complicate

diplomacy rather than adding to it, as reputational taints might not track closely with the requirements of diplomatic initiatives. Third and finally, policymakers should be cautious about using these sanctions too frequently, regardless of whether they are likely to be effective in a given circumstance. As discussed by current and former senior officials, their continued use may deter private actors such as international financial institutions from conducting the same level of business in U.S. markets for fear that their economic interests will be jeopardized by U.S. political goals.

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