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The Future of Financial Warfare in an Era of Great Power Competition

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Abstract:

In the aftermath of the 9/11 attacks, America's sanctions strategy shifted from the use of broad embargoes to narrower policy tools. Originally intended to stymie the financing of al-Qaeda and other terrorist organizations, these tools, especially dollar clearing restrictions, became effective weapons against rogue nation-states, like North Korea and Iran. With the return of great power competition, these tools carry increasing systemic and prudential risks to the global financial system, necessitating a policy shift in the US government's approach. For asset managers, new measures, including debt/equity restrictions or tightened export controls, are likely to have much more profound effects on supply chains, risk assets, and international economics generally.

Introduction:

In a new strategic moment of great power competition, it is vital to understand the strengths and limitations of America's current sanctions arsenal. The USA Patriot Act, passed in the wake of the 9/11 attacks, built a robust series of financial pressure tools designed to target the financiers of terrorism. Codified in Title 3, the Patriot Act built on past money laundering legislation, including the Bank Secrecy Act of 1970 and the Money Laundering Control Act of 1986, featuring innovative strategies to exploit terrorists' interaction with dollar-denominated capital markets. Toward these ends, Section 311 formed a powerful foundation, providing the Treasury Secretary with the discretionary power to closely monitor or even outright prohibit correspondent banking in dollars with financial entities that sponsor terrorism, labeling such actors as primary money laundering concerns. For any nation that seeks to pay for imports in dollars or receive dollars for its exports, correspondent banking is a necessary component of modern international trade. Without such access, institutions are effectively barred from transacting in dollars and, as a result, isolated from the international financial system.

In a world where the dollar reigns as the pre-eminent global reserve currency, this access is vital for any bank seeking to provide cross-border financial services to its clients. Thus, there are massive economic incentives for private banks to comply with American sanctions regimes, regardless of the stance of their respective governments. While there have been slews of scandals surrounding sanctions violations, they have, in principle, relegated and reduced much of the financial access provided to terrorist organizations. In response, terrorists have pushed more into non-traditional areas of finance, such as traditional hawala networks, by which entrusted couriers can conduct funds transfer without the physical transfer of cash.

Shortly after their creation, the Treasury and State also began applying this same toolkit against rogue states across the globe. Relative to the size, scope, and depth of both American consumer and financial markets, rogue states, like Iran and North Korea, provide very little economic benefit to global financial institutions. For the potential financial cost and reputational risk, the reduced deal sizes and client volumes in these jurisdictions are far from attractive. After the first deployment of a 311 against Banco Delta Asia in Macau for holding North Korean funds, financial institutions across Asia, from Northern China to Singapore, sought to de-risk their portfolios of any exposure to illicit flows from Pyongyang. The effect on BDA was remarkable, as its local depositors triggered a run by withdrawing cash and its accounts were frozen by local regulators.

Against Iran, the pressure was even greater. In addition to targeting financial institutions, like Bank Sepah or Bank Melli that were involved in proliferation, a 311 designation was placed on the Central Bank of Iran. Under this action, the entirety of the Iranian jurisdiction was labeled a primary money laundering entity as a result. In tandem with this move, Iranian banks were also disconnected from the Society for Worldwide Interbank Telecommunications (SWIFT), which effectively banned such firms from sending or receiving capital from abroad. The pressure applied through these policies, coupled with both an oil embargo by the European Union and a global regime of waivers that reduced Iranian oil purchases in India, Turkey, China, and more, brought Tehran to the negotiating table, as its hard currency accounts were frozen and its economy tanked.

While some activity has adapted to these sanctions, the dollar remains unrivaled in its depth or liquidity among major global currencies, and there is little near-term risk to its global clout from these measures. However, as Washington's strategic focus migrates from rogue states and counterterrorism to increasingly great powers, that is, revanchist or expansionist nation-states with capabilities rivaling our own, there is a dilemma in sanctions policy. Much like their expanded military or diplomatic presence in the international community, these great powers have a much larger footprint in financial markets. When Washington previously pursued rogue states and terrorist organizations, there were few, if any, risks to the global economy from isolating North Korean or Iranian finances. The same cannot be said about our new competitors, like Russia or China, who play key roles in global supply chains. Such clout also raises questions about the future of sanctions' effectiveness altogether, specifically if these larger economies can effectively undermine existing or develop alternatives to American institutions, or even retaliate against American firms in response.

Transition:

The size and scope of American financial markets have for decades attracted participation from international investors. Since the creation of the Federal Reserve in 1913, the U.S. Dollar has grown to be the primary global reserve currency, based on its use in trade invoicing, international borrowing, and central bank reserves. In tandem with the dollar's rise, global firms and asset managers have steadily increased their exposure to US assets, specifically using Treasuries as a hedging instrument in times of stress. Despite the rising clout of emerging markets, like China and India, the dollar's role has remained strong since the Financial Crisis and, if anything, has increased.

Politically, the strength of US institutions also plays a key factor in sustaining the dollar's global reserve function. This dynamic is less expressed by the temperament of US authorities themselves, and more so the effects of fiscal and monetary policy. Emblematic in the response to the Financial Crisis, Washington not only provided support to the domestic financial system via the Troubled Asset Relief Program or TARP, but also to global banks via dollar swap lines extended by the Federal Reserve. As many global banks had accumulated substantial dollar exposures tied to the subprime mortgage market, these swap lines were instrumental in preventing a run on global liquidity.

By contrast, the state of the euro's incomplete monetary union produced a more conservative, austere reaction to the crisis' effects in Europe. Within the Eurozone, the Sovereign Debt Crisis called into question the effectiveness of crisis management procedures, especially the willingness of euro-area governments to support distressed sovereigns. With this in mind, the crisis severely disrupted the euro's internationalization, given the heightened probability of the monetary union's breakup over these months. Beyond the eurozone, European authorities also failed to provide similar swap mechanisms for beleaguered economies in Eastern Europe that faced similar euro funding exposures as their German and French peers faced in dollar funding markets.

Relative to either the euro or the dollar, the institutional backing of the renminbi (RMB) is also weaker, owing to China's domestic political configuration. While Chinese regulators and the central bank can often produce effective prudential policies or stimulus measures, these officials, like the rest of the Chinese government, are accountable to the Communist Party first and foremost. Though this should not necessarily interrupt a Chinese response to a global financial crisis, it is likely to make international investors anxious about storing their reserves in RMB. There is also considerable precedent for China's own unilateral economic coercion, which will affect the context by which reserve switching into RMB occurs, should it take place at all.

The Evolution of Chinese Sanctions:

In the past, China has, much like the United States, weaponized access to its consumer market against its geopolitical rivals under varying jurisdictions. In the past, territorial disputes have motivated economic coercion against Japanese and Philippine markets, while arms sales have motivated similar measures against Korean and Taiwanese markets. In the future, China is likely to levy more sanctions tied to political circumstances, especially corporate involvement in politically sensitive affairs, ranging from the political protests in Hong Kong to the arrest of Meng Wangzhou.

Much like how the United States has weaponized access to its financial markets in the past, China can seek to lever the size and scope of its consumer market. The clearest and striking recent example is the Chinese response to the deployment of the Terminal High Altitude Area Defense (THAAD) System to Korea. Shortly thereafter, Chinese authorities began limiting market access to various Korean firms and sectors, often through informal means. Lotte, a large retailer who swapped its land for the missile site in particular, found nearly all of its mainland locations shuttered on charges of fire code violations. Korean cultural exports were scaled back by implicit bans on music tours and revoking approval of Korean TV content on Chinese streaming platforms, while group tourism packages to Korea were also banned. In parallel with these official state moves, state-owned media found a sympathetic audience in encouraging consumer boycotts of Korean brands, particularly in the automobile industry.

These ostensibly symbolic measures had a tangible economic impact, with the Bank of Korea estimating as much as a 0.4% hit to growth stemming primarily from reduced automobile exports and fewer Chinese tourists. Ultimately, Korea-Chinese tensions eased, while THAAD remained in place, but the influence of North Korean aggression cannot be ignored. Even Prime Minister Moon, who had displayed some measured skepticism towards THAAD, was forced into backing the program after North Korea's successive missile tests. Had these tests not taken place, the THAAD dispute and the resulting economic effect on Korea could have gone much differently. The most striking aspect of the dispute was that it went virtually unpunished, if even noticed at all.

Authorities in Beijing were not ignorant to this. Unlike American sanctions, which are formalized in the context of the rule of law, Chinese sanctions were passed informally. At no point could a direct finger be pointed at Beijing: Lotte's stores were shuttered because of fire code violations, while consumer boycotts were the product of nationalist social media. These factors make it not only difficult, but virtually impossible, for other nations to hold China accountable in international organizations over these infractions. It is no surprise that Korea, after some analysis, did not pursue China in the World Trade Organization during this dispute. More broadly, there were few easy options for the US, at least in its current framework.

Since the Korea dispute, China has deployed these tools more often and with a wider range of targets. Last year, Chinese aviation and cybersecurity officials threatened global airlines to remove separate references to Taiwan, Hong Kong, or Macau, as separate discussions from China. Just before this campaign, Marriott found its website shuttered by the China Cyberspace Administration after including separate references to Tibet, Taiwan, Hong Kong, and Macau in a customer survey. Naturally, the airlines gave in: China is projected to become the world's largest air market by the early 2020s, risking isolation in a market that could be central to their future growth. Though the White House took notice, there were no retaliatory measures prepared, either against Beijing or its unwitting corporate enforcers.

The logic of Chinese sanctions, much like the logic of American sanctions, is purely financial: companies have no choice but to comply with a request from a more lucrative market, so as to not threaten any potential commercial opportunities. Relative to the deep and liquid American financial markets or its sizable consumer market, no rational firm would continue doing business in a small, sanctioned jurisdiction, like North Korea or Iran. Not only is this true in China, but to an even more dramatic instance: China is not merely a large consumer market already but will grow to be an even larger market in the future. Not only do firms not seek to lose their existing access; they want to gain more access in the future, which requires good relations with the Communist Party. There are few, if any, policy measures that Washington can adopt to change this calculus without risking a serious upset in markets and international trade.

Knowing this, these measures resurfaced amid the protests in Hong Kong this summer, with many multinationals catching Beijing's ire, none more so than Cathay Pacific ("Cathay"). Amid the city's crackdown on the protests, the arrest of a Cathay pilot triggered a sharp response from Chinese regulators. The Civil Aviation Administration of China demanded that Cathay turn over a manifest of its staff working on mainland flights, with any staff participating in the protests being barred from these flights. The CEO of Cathay's parent, Swire, was also called in to meet with the Civil Aviation Administration, with Cathay's CEO, Rupert Hogg, resigning several days after. Still, the damage had been done: not only did nationalist media call for a boycott, but several state-owned enterprises, including Huarong Asset Management, China Resources National, and CITIC Group[1], joined in as well, telling staff not to fly the airline for corporate or personal travel. Cathay's case is significant not only from a sanctions perspective, as China appears more willing to formally weaponize market access, but also from an individual rights standpoint.

Cathay was far from the only firm targeted for its employees' alleged involvement in the protests, with the Big 4[2] also coming under scrutiny. After several employees allegedly crowdfunded a pro-demonstration advertisement, the Big 4 fell into the sights of nationalist media. As such, Chinese regulators are not the only relevant actors in this new sanctions policy, but also the country's nationalist internet users, commonly dubbed "netizens." These netizens can closely monitor the behavior of employees to find firms to pressure, crafting a sanctions strategy with the ultimate objective of silencing criticism of China abroad. In such cases, Western firms are no longer the victims of Chinese policy, but rather, its enforcers. As China has grown more confident in its ability to wield informal pressure without punishment, the capacity to levy formal punishments grows.

In the future, China has, to some degree, laid the foundation for a series of tools that could be used for an organized sanctions campaign against a local foe. In response to the Commerce Department's designation of Huawei under the Entity List, Beijing unveiled its own Unreliable Entities List. Though no firm has been officially designated, such a classification could include Western suppliers who have severed their export relationships with Huawei after the Entity List designation. Over a longer-term period, firms enforcing Western sanctions against Chinese firms over involvement in North Korea or Iran could also be at risk, as well as firms that cooperate with US regulators against Chinese firms in such cases, such as HSBC's role in the Meng Wangzhou extradition case. The scope for Chinese retaliation extends well beyond specific cases, leaving the window of uncertainty open and complicating America's sanctions policy in an era of great power competition.

Not only is China now developing its own sanctions, but in doing so, Beijing could threaten the compliance incentives that have supported American sanctions, even in times when foreign governments have opposed their use. Despite many European governments' opposition, European firms have complied with American sanctions for fear of losing access to dollar clearing or losing business from American clients. While the RMB is far from rivaling the dollar, the size of the Chinese market is such that in any bilateral sanctions confrontation between Beijing and Washington, the decision making calculus of multinationals will be far dicier than in the past. Dollar access will likely remain most important for financial institutions, but some sanctioned entities have begun developing workarounds to reduce this risk.

Russia's Sanctions Strategy and Multipolar Reserve Currency Regimes:

Amid the ongoing sanctions package tied to Russia's involvement in Crimea, the Kremlin has dedicated significant resources and political effort toward building alternatives to the dollar in its trade and financial infrastructure. Yet relative to Iran, Russia sanctions were crafted in a much more fragile political and economic framework, owing to the deep links between the Russian and European economies, especially in energy. These relationships are such that a comprehensive energy embargo, like that passed against Iran, would be unfeasible, given steep economic and political costs. Similarly,

[1] CITIC Group is formerly the China International Trust Investment Corporation

[2] Big Four Banks references the Federal Reserve, the Bank of England, the Bank of Japan, and the European Central Bank

Russian banks were thought to be too large in the past to be effective targets for dollar clearing restrictions, risking macroeconomic spillover effects.

Thus, Russia was targeted with a complement of unique sectoral and financial sanctions. On the sectoral side, Brussels and Washington pressured the Russian energy and defense industries with restricted access to Western technology exports, especially new drilling techniques. Financially, Russian banks and other state-linked firms were hit with debt and equity restrictions, cutting off their access to euro- and dollar-denominated capital markets. In addition to these moves, both entities have since taken steps to isolate and pressure specific oligarchs, seeking to disrupt the Kremlin's political economy, by which Putin distributes the country's plundered wealth within his inner circle. Though Russia remains in Crimea, the sanctions have had a material economic impact and likely deterred additional escalation at the time in Donetsk and Lugansk.

On a micro level, Western sanctions have been effective at shifting the calculus of individual oligarchs tied to the Putin regime. Most notably, the sanctions passed against Rusal, which disrupted global aluminum markets for a short period, were successful in forcing Oleg Deripaska to reduce his ownership interest, limiting his ability to capture wealth from its profitable operations. Other oligarchs, like Roman Abramovich, have distanced themselves from Western capitals completely, with Abramovich moving to Israel after failing to receive an updated visa after the Skripal attacks. Given the Kremlin's role in buying the loyalty of Russia's wealthy by facilitating the flow of illicit gains, personal sanctions against the oligarchs could be explored as a way to place additional pressure on the regime and its decision-making calculus.

Already, the Kremlin has taken steps to reduce its vulnerability to sanctions, most notably with alternative infrastructure. After the sanctions were implemented, the Central Bank of Russia and the National Payment Card System developed an alternative to Visa or Mastercard, known as Mir. Despite payments processors not being forced out by sanctions, the Kremlin became sensitive to the potential for their withdrawal, as well as the selective withdrawal of services to sanctioned entities or individuals. To boost its use and circulation, Russian law stipulates that banks use Mir for welfare and pension payments. In early 2019, as many as 56 million Mir payment cards were in circulation, and the card has inked agreements with Mastercard, JCB, and UnionPay. Now studying vectors for global expansion, Mir cards have expanded into several other countries, including Armenia, Belarus, and Kazakhstan.

On a higher level, Russia has also held talks with China, India, Iran, and Turkey about increasing the use of its domestic alternative to SWIFT, known as SPFS, which is also managed by the Central Bank. Seeking to hedge the possibility of an Iran-style SWIFT expulsion, Russia has sought to cultivate greater use of this network, but to little avail. Even if the network became more widespread, it is still unlikely to hedge or meaningfully reduce the serious consequences of SWIFT sanctions, as well as being a tough sell for other nations not currently facing sanctions, especially China and India. Beyond physical infrastructure, the country has made much more meaningful shifts in its invoicing and reserve behavior, potentially limiting the future effectiveness of an escalation in sanctions.

In its invoicing behavior, Russia has shifted to a much more widespread use of the euro, especially in cross-border trade with the European Union and China. While the EU has been a vital ally in sustaining the existing sanctions, European political dynamics render sanctions much more difficult to pass than in the United States. For Moscow, this makes the euro attractive, knowing that European authorities are unlikely to pass comprehensive euro-clearing restrictions in the same manner as Washington. The country has also shifted the composition of its foreign exchange reserves, selling off nearly $100B in Treasuries last year, before reinvesting into different currencies, like the euro, RMB, and the yen. For future policy action, the Russia case offers a few key lessons for both sanctions practitioners and market participants alike.

The sanctions that were initially innovative in the aftermath of 9/11 and caught both terrorists and rogue states off-guard are now nearly two decades old. Kleptocrats have invested heavily in finding or developing loopholes in regulatory frameworks, which are then exploited to undermine the influence of a sanction. Though Russia is far from immune to the power of Treasury's legislation, the Kremlin is taking steps to reduce its use of dollars to meaningfully impact the economic consequences of sanctions.

Conclusion & Policy Recommendations:

In conclusion, much as there was a material shift between the pre- and post-9/11 era, the Treasury and State Department's approach to sanctions should evolve for this new era of financial warfare. Relative to the past, benchmark tools, especially the 311 designation, are ill-equipped for the necessary precision to tackle the emerging AML/CFT threats posed by central banks and sovereign wealth funds, among other actors, amid renewed great power competition. At the same time, emerging tools, such as equity and debt restrictions or expanded export controls, risk new forms of macroeconomic disruption to cross-border flows of goods and capital alike. Recognition of this new reality is a necessary first-step to evolving the sanctions doctrine in the 21st century.

Moving forward, a greater emphasis on sovereign wealth funds is warranted, not only in jurisdictions with active sanctions regimes, like Russia, but in jurisdictions generally where their economic footprint has expanded, especially in the Middle East. Since the cratering of oil prices, Gulf sovereign wealth funds have boosted their investments in illiquid asset classes, including private equity, venture capital, and infrastructure. In tandem with both rising valuations and the market cycle more broadly, these flows have abated to some degree, but existing investments warrant further scrutiny.

Sovereign wealth funds' influence is far from constrained to international market, as the rise Yasir al-Rumayyan's standing shows, having taken over from Saudi Aramco's traditional leadership as Chairman of the Board, while also serving as the head of the PIF. This is a trend far from limited to just Saudi Arabia. In Russia, since the passage of sanctions, the Russia Direct Investment Fund has taken on a greater footprint in domestic and international economy, typically in tandem with other sovereign wealth funds or foreign investors. The Russia Direct Investment Fund has collaborated with the PIF on several energy projects, fitting the de-facto transition in OPEC leadership to Moscow and Riyadh. In Turkey, Erdogan has also bolstered his influence over the Turkish wealth fund, whose creation he oversaw, and hehas deployed it to assuage pressures in the domestic economy since the country's financial crisis last summer. The increasing use of sovereign wealth funds not just for investments in a wider array of international assets, but also for domestic political goals, highlights their role in forming new and entrenching existing patronage relationships, providing a fertile ground for kleptocratic activity.
Access to dollar-denominated capital markets is a significant benefit for these funds, but that is not a blank check for further restrictions. Following the passage of Justice Against Sponsors of Terrorism Act in 2016, many Gulf sovereigns became heavily concerned about the potential seizure of their assets, tied to cases dating back to the 9/11 attacks. Though the merits of such legislation should be debated separately from sanctions, these measures could be disruptive if used flagrantly against larger jurisdictions, in a similar manner as the 311 designations. Given the confluence of political factors that, in addition to financial factors, drive sovereign wealth fund investment activity, some funds may be willing to pay a premium for assets located outside of Treasury's regulatory jurisdiction, should their sovereign see significant risk from sanctions exposure.
Central banks also pose a challenge, though for less directly kleptocratic reasons, as they may possess the capacity to mollify some of the negative economic effects of future sanctions legislation. As the ongoing trade war demonstrates, the Federal Reserve domestically has been willing to cut rates, as part of a mid cycle adjustment, driven in part by depressed business investment spending influenced by US-China trade tensions. Should other jurisdictions face similar pressures, but tied to sanctions, rather than trade policy, there is some scope for central bank action to mitigate negative economic pressures. Further, as the Russia case shows, central bank activity against these pressures may also include pre-emptive action, such as the sale of dollar reserves and reinvestment of the proceeds in other capital markets. While there will no doubt be higher liquidity costs and an ever-present supply constraint to such flows, there is potential for expanded sales, as part of sanctions hedging, that could be lead by central bank flows. Still, the potential compositions of these policy packages are foggy at best, complicating any resulting action to tackle them, unlike with sovereign wealth funds, where kleptocratic potential is fairly straightforward. Sovereign wealth funds may benefit from existing initiatives, like the Santiago Principles, in holding kleptocrats accountable, but there is no comparable framework for central banks at this point.
As such, in an era of great power competition, sanctions practitioners should not merely focus on the contours of a hypothetical sanctions program, in response to idiosyncratic country factors, but also on the broader macroeconomic context for markets. The Treasury and State should not just focus on the influence of these new state actors, as it relates to one jurisdiction or another, but as a global phenomenon. This will require new talent and expertise, but is absolutely critical to the future viability of sanctions in their evolving form. More generally as well, a recognition that sanctions alone are not sufficient to supplant a broader strategy, crossing the diplomatic, military, and cyber frontiers, is warranted: sanctions should not simply be the first notch in Washington's reaction function, but rather be carefully thought-out tools of international statecraft. The window for reform is narrowing, as rogue states increasingly adapt to American sanctions techniques and develop time and effort to workarounds. Though no workaround has been successful yet, the political pressures generated by activist sanctions policy over the past several years has provided fertile political ground for one, ranging from Europe's INSTEX to Russia's expanded use of the euro.