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GEOECONOMICS CENTER

THE FUTURE OF THE UNITED STATES DOLLAR:

Weaponizing the US Financial System

Michael B. Greenwald

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Cover image: “Image of president on American dollar bill” by Skyler Ewing, Pexels *https://www.pexels.com/photo/image-of-president-on-american-dollar-bill-4597810/*.

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Part I: What COVID-19 Means For the United States' Economic and Financial Statecraft

COVID-19 has triggered a deeper recession than that of the 2008–2009 global financial crisis. As in that crisis, monetary authorities at the US Federal Reserve have taken unprecedented actions to support liquidity in global markets. These steps have included support for domestic debt markets, including a recent expansion in the corporate bond market, as well as swap lines targeting the global dollar shortage. Beyond these moves, the broader policy response during and after the COVID-19 outbreak may drive longer-term changes in the global trading system.

Last December, the Phase One US-China deal signing spared US consumers from increased tariff burdens on key consumer goods. As COVID-19 triggered large shutdowns in the Chinese economy, disrupted supply chains immediately raised questions about the deal's purchase targets. Under the arrangement, China is slated to buy $200 billion in US exports, but this number is increasingly dubious amid subdued Chinese economic data. Even before COVID-19, the outlook for a more comprehensive Phase Two deal was hazy—but after, it is a pipe dream.

Much of the developed world is now experiencing the greatest economic disruption since the Second World War. Pharmaceutical supply chains have found themselves at the center of discussion as countries face shortages of ventilators, facemasks, and other key commodities. In 2020, several nations, including South Korea, Taiwan, Germany, and Russia, placed restrictions on medical equipment exports. The European Union (EU) even imposed temporary export-authorization requirements for exports of personal protective equipment outside of the European Union.

Though not particularly disruptive in and of themselves, these moves raise questions about the longer-term focus of trade policy in a post-COVID world. Pharmaceutical supply chains of all stripes, beyond protective equipment, may be a renewed victim of trade pressures, as different nations focus on alleviating future shortages. Such policy moves may, in fact, be justifiable, given the significant national security concern associated with pandemics like COVID-19. Full free and fair trade may be little consolation amid another global outbreak that once again strains healthcare systems internationally.

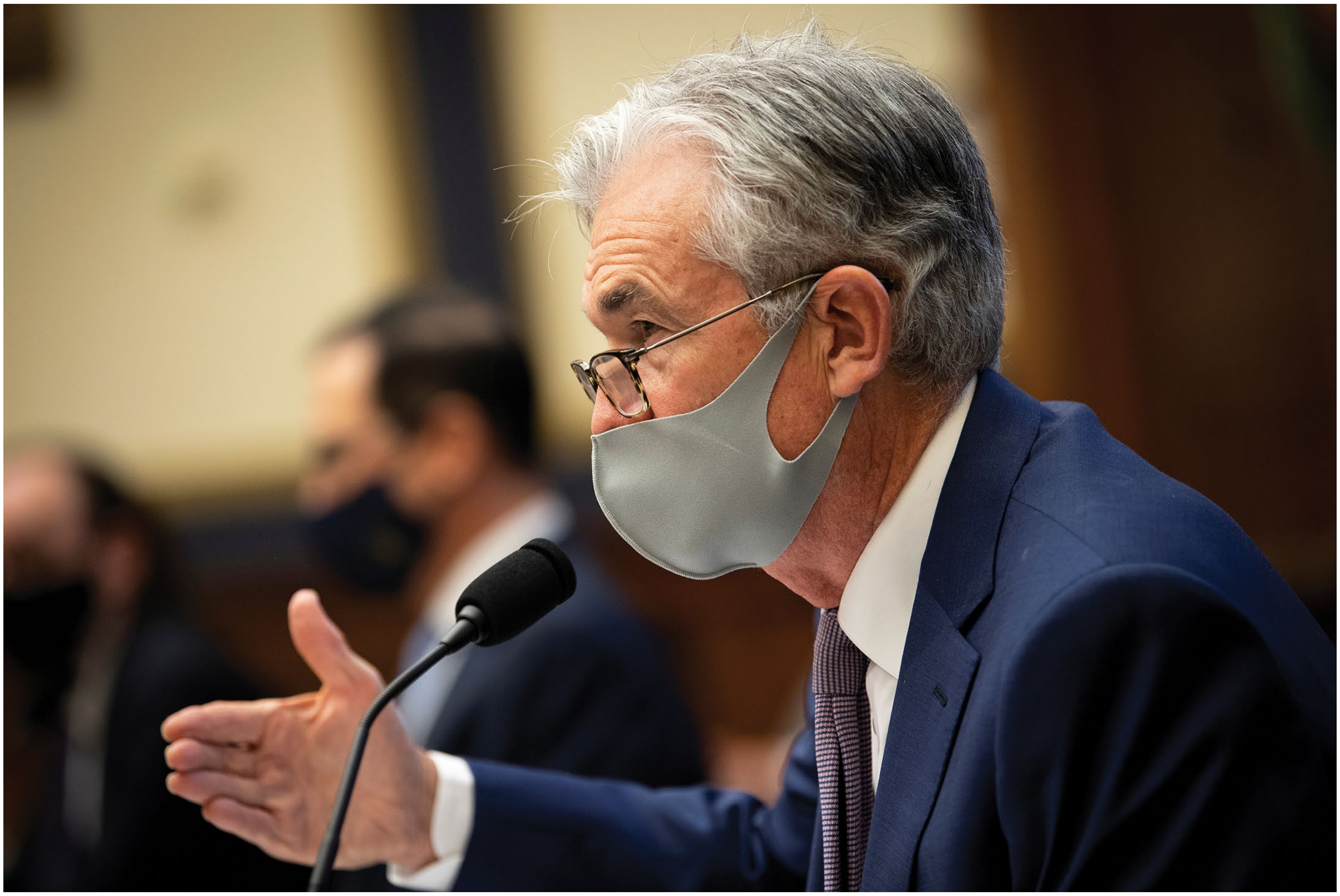
Should the US-China trade war return with a vengeance, it will do so at a uniquely weak juncture in global trade relations. In December, US efforts saw the World Trade Organization's (WTO's) Appellate Body, normally a seven-member committee, lose two of its final three judges amid Washington's blocking of new judges. Earlier this month, Washington escalated its campaign by accusing Zhao Hong, the final trade official in the body, of compromising ties to the Chinese government. Against the context of accelerating unilateral protectionism, the WTO's ineffectiveness in this period may set the stage for more confrontation ahead.

Ensuring sufficient stores of medical equipment, especially in the face of COVID-19, is a strong argument for expanding incentives for domestic manufacturing. As the rest of the world faces the same dilemma, it is almost certain that other nations will respond, and that response will almost certainly come at the expense of US multinationals. Should this path be pursued, the tools of US statecraft will have to manage the foreign fallout of these policy moves, but doing so will be far from easy.

Cooperation and coordination with allies may be the solution to mitigating these migrations from triggering greater instability in the global economy, but Washington's traditional partners have been spurned by an increasingly burdensome statecraft. Outside of trade, the US Treasury Department's expansive sanctions program have enflamed transatlantic tensions by weaponizing the dollar's role as the leading global currency. Despite harsh rhetoric about exploring alternatives, major European firms and governments have remained connected to the infrastructure of the global dollar, but COVID-19 may be changing this.

The dollar's role as a central reserve currency has rested not on political coercion, but on vital economic incentives. The depth and liquidity of dollar-denominated financial markets is unparalleled globally, particularly in debt markets. For decades, US debt markets have absorbed the savings of European investment banks, Japanese pension funds, Taiwanese insurers, and even the People's Bank of China. In simple terms, were those dollar haven seekers to switch to the euro, there simply would not be enough safe bonds to go around.

Seeking to finance the continent's response to the virus, nine Eurozone nations have pushed for a pan-European debt issue. This action would correct one of the monetary



U.S. Federal Reserve Chair Jerome Powell testifies before a House Financial Services Committee at a hearing on oversight of the Treasury Department's and Federal Reserve's coronavirus disease (COVID-19) pandemic response on Capitol Hill in Washington, U.S., September 22, 2020. *Caroline Brehman/Pool via REUTERS*

union's key flaws in pushing the euro as a reserve currency: its lack of a common fiscal policy. Though Berlin will ultimately have the final say, Germany has already launched an $814-billion stimulus package in response to the virus' effects, with slated debt issuance of about 4.5 percent of gross domestic product (GDP). German government bonds, known as Bunds, have functioned as the Eurozone's de facto safe asset, in lieu of pan-European bonds. President Christine Lagarde and the European Central Bank still have considerable flexibility to achieve the same goal of mutualized debt, even without the Eurobond name.

Should the COVID crisis, in fact, be the Eurozone's moment of truth, there will be serious consequences for the treasury. A more united and stable Eurozone—and, with it, a more international euro—is in Washington's economic interest. Though a transatlantic economic rapprochement is long overdue regardless of the crisis' outcome, these effects would make it necessary to return to a more multilateral approach to statecraft or risk deep, long-lasting consequences to the United States' global standing.

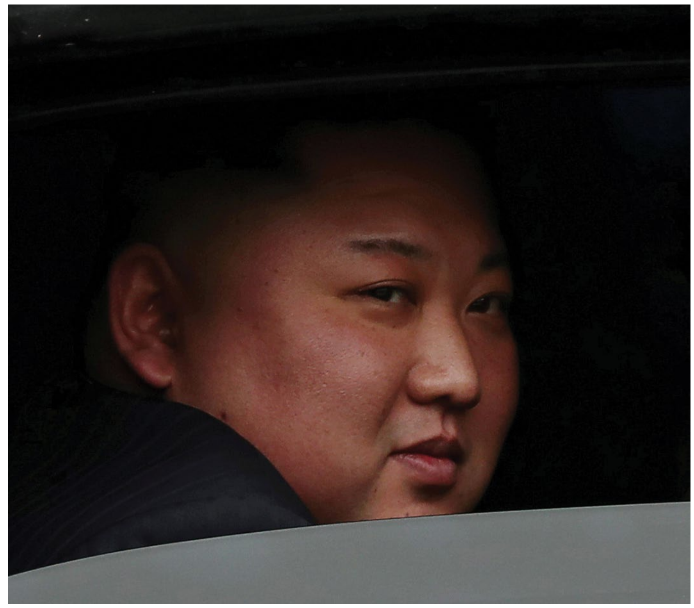
Part II: International Monetary Exchange and Illicit Financial Activity

As the world has grappled with kleptocrats, terrorist groups, and rogue states in the twenty-first century, there has been no greater lifeblood for these bad actors than the international financial system. To the average person, money means a paycheck, savings account, or even the physical cash inside of one's wallets. People can use loans to increase their own effective cash supply, but this comes with an embedded cost of paying interest in the future. Interest is one of the many costs that can consume one's money, ranging from interest on car loans to interest on mortgage loans to interest on credit-card loans, and many more examples. In sum, money relates to an individual's life in how it can be used to consume goods or pay off expenses.

For a bad actor internationally, money adds an even more significant political role. Take the example of North Korea, wherein there exists a semblance of a legitimate, competitive economy in the form of state trading companies. These companies, owned by the Korean People's Army, Workers' Party of Korea, or other state apparatuses, have become more and more significant to the regime's survival, as economic and financial isolation has deepened.[1] Today, these state trading companies are the primary channel by which hard currency enters the hermit kingdom, where it can fuel a wide variety of purposes.

When the money first enters the country, a small portion is typically deposited into Kim Jong-Un's personal bank accounts, where it is used both for personal expenses and for greasing the patronage networks that ensure the support of the elites for the Kim family. The remainder is used to finance the budgets of its affiliated group, including the country's nuclear program.

This is not a model exclusive to North Korea, where money has financial, political, and, by extension, cultural influence. In Russia, access to international financial services, ranging from London bank accounts to Miami real estate, has become a significant hedge on the Kremlin's ambitions for the country's oligarchs. By moving money outside of the Russian mafia state's jurisdiction, oligarchs maintain an impressive insurance policy on their standing within the Vladimir Putin regime. From billionaires like Yuri Milner to tech entrepreneurs like Pavel Durov, fleeing to the West has proven an attractive and even necessary option, which, in turn, necessitates a financial presence in the West.[2] In this way, the role of money evolves from a political necessity to a personal necessity.



North Korea's leader Kim Jong Un sits in his vehicle after arriving at a railway station in Dong Dang, Vietnam, at the border with China, February 26, 2019. *REUTERS/Athit Perawongmetha/File Photo*

In the same way that average, middle-class consumers use money to pay their expenses, so too do oligarchs and kleptocrats use money to pay theirs—only, in the case of the latter, those expenses range from personal insurance on an unstable leader through foreign investment to greasing patronage networks domestically to maintaining an illegal nuclear program. This has not gone unnoticed in Washington.

1 John Park and Jim Walsh, "Stopping North Korea, Inc: Sanctions Effectiveness and Unintended Consequences," MIT Security Studies Program, August 2016, https://www.belfercenter.org/sites/default/files/legacy/files/Stopping%20North%20Korea%20Inc%20Park%20and%20Walsh%20.pdf.

2 Sian Bradley, "What's the Deal with Milner, Facebook, Twitter, and Russia?" *Wired*, Nov 7, 2017, https://www.wired.co.uk/article/what-is-the-paradise-papers-leak-facebook-yuri-milner-facebook-twitter-russia; Danny Hakim, "Once Celebrated in Russia, the Programmer Pavel Durov Chooses Exile," *New York Times*, December 2, 2014, https://www.nytimes.com/2014/12/03/technology/once-celebrated-in-russia-programmer-pavel-durov-chooses-exile.html?auth=login-email&login=email.

Part III: Bretton Woods and the Weaponization of the Dollar

A) Capital Flows

The complex, interconnected system of international finance has fueled the rise of an ambitious financial statecraft agenda in Washington. To put "international finance" in perspective, the significant use of economic sanctions in international statecraft can arguably be traced back to the Megarian Decree.[3] Issued by Athens ahead of the Peloponnesian War, the decree stipulated that residents of Megara, a strategic Greek city-state, would not be allowed to service ports throughout the Athenian sphere of influence. Historians originally saw this as the trigger for the resulting Peloponnesian War, but later analyses have downplayed its significance, contextualizing it within a period of rising tensions.[4]

In the modern era of international finance, the politics and customs surrounding port entry have been substituted for international flows of capital. By flows of capital, economists refer to the financial or monetary transactions in international trade. If one walks into a television store and purchases a TV for $500, the transfer of the good (the TV) must be matched by a corresponding financial transaction (the $500). As financial globalization has erased borders and divisions, these flows have grown more and more influential.

The Asian Financial Crisis of 1997 provides a key example. Flows of international capital into East Asian bonds denominated in foreign currency played a key role in first overheating, and then correcting, East Asian economies. Prior to the crisis, domestic banks lent excessively to unprofitable domestic ventures and then borrowed heavily in international markets. By denominating their bonds in foreign currency, typically the dollar, these borrowers received lower rates of interest. Eventually, as the dollar appreciated in value, it became more and more expensive for Asian borrowers to exchange their domestic currencies into dollars to pay their creditors.

At the heart of this dynamic system is the international role played by the dollar. The US economy overtook England as the world's largest in the mid-nineteenth century. The dollar's rise to prominence began in 1913, with the twin establishment of the Federal Reserve and repeal of overseas branching regulations.[5] By the 1920s, the dollar and pound operated in rough parity to one another, though the Great Depression would throw the international monetary system in flux once more, with the dollar reestablishing itself at the Bretton Woods Conference in 1944. Following the widespread war payments made to the United States in gold during World Wars I and II, it became clear that it wouldn't be feasible to return to a global gold standard in international finance. At this conference, the world's leaders determined that in order to link global currencies to the gold that they had paid to the United States for war goods, they inevitably had to link them to the US dollar.

B) The Effects of Bretton Woods

Consequently, the dollar was pegged to a fixed exchange rate with gold, and the global economy set out on a path of increased financial reliance on the performance of the US dollar. As a result of the Bretton Woods agreement, the dollar was determined to be the world's reserve currency, and has since proved its stability and resilience in the worst of economic crises, providing a reliable currency that populates 88 percent of all foreign reserves. Since this time, the world has maintained its trust and confidence in US treasuries, and these securities remain the safest store of money due to the dominance of US financial markets.

What gives the United States such a remarkable "privilege" in the international financial environment is the ability to issue debt at much lower rates than other countries, due to the desire of nations to secure US debt, which can continue to be issued as long as it is in demand. When it comes to the use of sanctions and financial diplomacy, it is clear why the United States has such a powerful economic weapon. According to an article by Peter Goodman in the New York Times, "...banks cannot risk jeopardizing their access to the plumbing of the dollar-based global financial network (and) they have taken pains to steer clear of nations and companies deemed pariahs in Washington."[6]

3 Brian R. MacDonald, "The Megarian Decree," *Historia: Zeitschrift Für Alte Geschichte* 32, 4, 1983, 385–410, http://www.jstor.org/stable/4435862.

4 Ibid.

5 Barry Eichengreen and Marc Flandreau, "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading International Currency?" *National Bureau of Economic Research*, July 2008, https://www.nber.org/papers/w14154.pdf.

6 Peter Goodman, "The Dollar Is Still King. How (in the World) Did That Happen?" *New York Times*, February 22, 2019, https://www.nytimes.com/2019/02/22/business/dollar-currency-value.html.

Since then, access to international dollar financing has allowed foreign entities, like East Asian banks, to benefit from lower rates of interest. Due to the stability and international use of the dollar, it is attractive for creditors to be paid in dollars, as opposed to payment in local currencies, like the Thai baht or the Malaysian ringgit.

In the aftermath of 9/11, the international role played by the dollar—not just in denominating bonds, but also in trade settlement, central bank reserves, and global payments—has also benefited the financial warriors of the State and Treasury Departments. Since then, Washington has leveraged the central role played by the dollar, which is governed by US law, to enforce sanctions against terrorist groups and rogue states. The rapid growth of these rules and regulations has become a critical part of Washington's counterterrorism arsenal.

C) Policy Actions

Financial sanctions have been utilized as policy tools from Macau to Mali, targeting both state and non-state actors alike. In their construction, these tools have in many cases targeted the risk calculus of individual firms, sidestepping national governments and international politics. These actions have ranged from asset freezes aimed at individual actors to the designation of entire jurisdictions as money-laundering havens. While the jury is out on their ability to influence national governments' decision-making, they have radically changed how corporations address political risk in the twenty-first century.

From the buccaneers of the sixteenth century to the trading floors of the twenty-first century, rules and restrictions inevitably create lucrative markets for evasion. While Washington built an impressive sanctions apparatus, at its heart was an enforcement arm that soon became the bane of multinationals caught in its sights. The more isolated specific markets became, the more the potential payoff of sanctions evasion grew.

BNP Paribas, the largest bank in France, was able to mask its continued involvement in Sudanese financial transactions by concealing the involvement of sanctioned Sudanese officials and enlisting the aid of third-party satellite banks.[7] The BNP office in Geneva soon handled a quarter of the country's exports and a fifth of its imports through its letters of credit, while its accounts were home to 50 percent of the country's overall foreign-currency assets. But, the bank's illicit dealings soon came home to roost, and it faced a mammoth $8.9-billion fine, courtesy of the Department of Justice.[8]

The costs of sanctions evasion are not just monetary, but also reputational. If one party facilitates sanctions evasion, there is the potential for all of that party's business partners to unwittingly involve themselves in criminal activity. This has the net impact of discouraging business. In one instance, Huawei's use of an affiliated third party, Skycom, to evade Iran sanctions cost the firm its close relationships with Standard Chartered and HSBC.[9] The risks of paying hundreds of millions, or even billions, in fines outweighs the potential revenue from a single client, which is why sanctions work.

Moreover, the mere possibility of sanctions being imposed can be enough to drive firms' behaviors, even absent any tangible policy choices or designations. There is an added psychological component to economic sanctions; the fear of fees, fines, and other penalties can be just as effective as a sanction itself. Further, as sanctions proliferate, their costs are felt not only by individuals and firms; entire jurisdictions can suffer the consequences.

The Megarian case only affected Megarian trade with Athens. Athens was no doubt a formidable player in Greek commerce, but this was not the end of the world for the Megarian economy; after all, it could still trade with Corinth and other city-states. One would be forgiven for assuming that in the present larger world, sanctioned states like Megara would have even more potential alternate business partners.

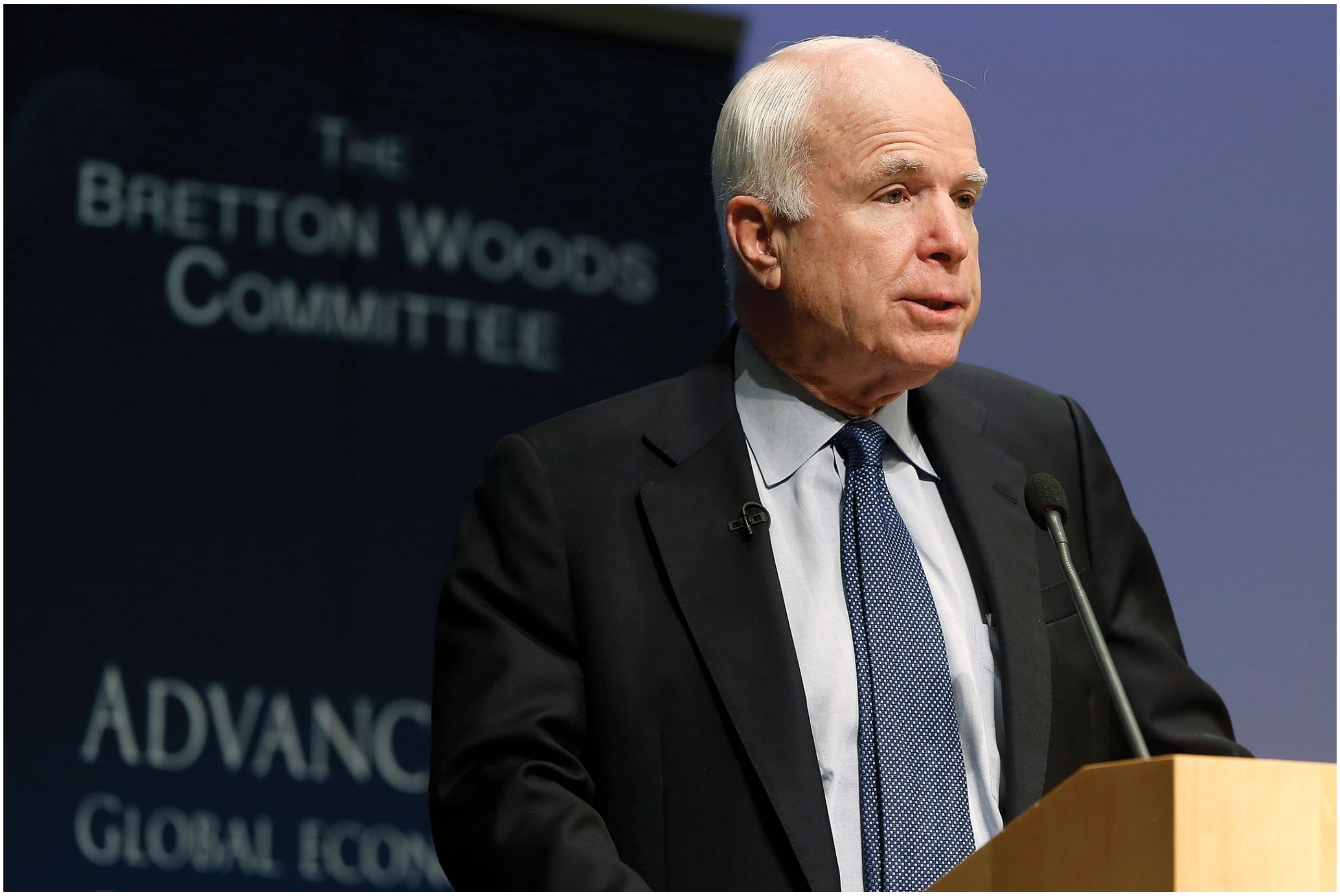
However, that would be mistaken. The fact that the global economy is so interconnected means that sanctions affect everybody—even non-sanctioned states. Today's boogeymen—China, Russia, and other spoiler states—are also affected by the weaponization of the dollar. China's tech champions—Alibaba, Baidu, and Tencent—all have primary exchange listings abroad, with Alibaba and Baidu both on the New York Stock Exchange.[10] Russian banks, like Sberbank and VTB, rely on access to the dollar for the continued normal functioning of their business. Industrial & Commercial Bank of China (ICBC) is one of the largest

7 "BNP Paribas Agrees to Plead Guilty and to Pay $8.9 Billion for Illegally Processing Financial Transactions for Countries Subject to US Economic Sanctions," Department of Justice Office of Public Affairs, June 30, 2014, https://www.justice.gov/opa/pr/bnp-paribas-agrees-plead-guilty-and-pay-89-billion-illegally-processing-financial.

8 Ben Protess and Jessica Silver-Greenberg, "BNP Paribas Admits Guilt and Agrees to Pay $8.9 Billion Fine to the US," *Dealbook*, June 30, 2014, https://dealbook.nytimes.com/2014/06/30/bnp-paribas-pleads-guilty-in-sanctions-case/.

9 Margot Patrick and Julie Steinberg, "Some Global Banks Break Ties With Huawei," *Wall Street Journal*, Dec 20, 2018, https://www.wsj.com/articles/some-global-banks-break-ties-with-huawei-11545321306.

10 "Alibaba IPO: The Biggest IPO in History," New York Stock Exchange, September 29, 2014, https://www.nyse.com/network/article/Alibaba-Lists-on-the-NYSE.



U.S. Senator John McCain (R-AZ) addresses the Bretton Woods Committee annual meeting at World Bank headquarters in Washington May 21, 2014. *REUTERS/Jonathan Ernst*

players in the Treasury Department repo market.[11] The size and scope of US financial markets ensure that while policymakers have leverage over foreign firms, these firms are incentivized to abide by sanctions policies, in the first place, by the US ripple-effect economy.

For the world's kleptocrats and money launderers, these are already hard-learned lessons from the past several decades. Already, these players have mastered complex, alternative financial structures that exploit weaknesses, gaps, and inefficiencies in the Treasury Department's sanctions authority. Moving forward, it will become critical for the United States to master the second generation of economic statecraft. More than ten years since the first deployment of targeted ("smart") financial sanctions, nations are adjusting, exploiting vulnerabilities within the ecosystem of the dollar.

Sanctions enforcement does not exist in a vacuum but, rather, within complex and intertwined global markets. The 2008 financial crisis demonstrated how the collapse of one bank can have ripple effects throughout not just the domestic financial system, but also the global one. New sovereign actors have emerged as critical players in the international capital markets, whose size and influence can deter future policymakers at the Treasury Department.

As Western investors have fled the Russian market, they have been increasingly replaced by Middle Eastern sovereign wealth funds that blend together politics and investment. These actors, large enough to make significant investments, are hard to sanction because of their diplomatic associations.

On a more macro level, central banks have the potential to play a substantially more disruptive role in Washington's calculus. In one case, large Russian banks, like VTB and Sberbank, have explored the possibility of using the Russian central bank's dollar-correspondent accounts, should theirs be cut

11 Miles Weiss, "With 260-to-1 Leverage, a Chinese Giant Takes on Goldman in Repo," Bloomberg, June 5, 2017, https://www.bloomberg.com/news/articles/2017-06-06/with-260-to-1-leverage-a-chinese-giant-takes-on-goldman-in-repo?sref=a9fBmPFG.

off by sanctions.[12] Were this to occur, Washington would face a tough choice: sanctioning a central bank and risking global financial stability, or letting Russian banks off the hook.

In a more ominous case, Visa and Mastercard, both private corporations, temporarily restricted clearing for several banks with ties to sanctioned oligarchs.[13] Due to the critical role played by these firms in payments processing, their exit came at a considerable cost to both the Russian economy and the Kremlin itself. As the Russian central bank established an alternative payments platform, Mir, Visa and Mastercard's Chinese competitor, UnionPay, offered an enticing, if elusive, model for Russian policymakers.[14]

Unlike most of China's state-owned enterprises, UnionPay is owned directly by the central bank, the People's Bank of China, rather than by the government itself.[15] If, in the future, UnionPay were to violate US sanctions, the Treasury Department would be forced to target the central bank of the second-largest economy in the world and one of the largest foreign investors in the treasuries market. To pursue this course of action would be tantamount to triggering another international financial meltdown and ending the dollar's role as a reserve currency. This demonstrates how nations can leverage power (and disguise a state agenda as private-sector activity) to dissuade sanctions or escape the consequence of international pressure.

D) Beyond Sanctions

While central banks and sovereign wealth funds have the potential to insulate investors from sanctions risk, sanctions are no longer the only weapon in the global financial wars. In the post-crisis environment, the need for financing in developing markets, as well as the resulting rise in debt, has sparked greater interest in the political advantages of lending.

In arguably the most sophisticated use of weaponized lending, the Kremlin lent $3 billion to Ukraine in 2013 through a Eurobond, purchased entirely by Russia's sovereign wealth fund.[16] As the post-Euromaidan Kyiv government appealed to the International Monetary Fund (IMF) for a bailout, a problem emerged: the IMF's official rules prevented emergency assistance to a country in arrears to official creditors (as opposed to private ones). As early as 2013, IMF researchers had identified this as a vulnerability that could allow a bilateral creditor to block IMF assistance by refusing to participate in a restructuring.[17]

Moscow switched its position from arguing that this was a private debt to arguing the Eurobond was merely a market-tradable instrument. Against this backdrop, the Kremlin theoretically possessed the leverage to destabilize the IMF's assistance. The IMF swiftly altered its policies accordingly, but the Kremlin moved to sue Kyiv under English law. While the Ukrainians have since appealed the court's ruling, Justice William Blair found in favor of Moscow. In this specific instance, Moscow did not have to create alternative financial structures of its own by avoiding dollars or creating parallel institutions. Moscow was able to pursue the more convenient path of using the West's own international financial institutions to intimidate another nation, a strategy repeated in Venezuela.

Beyond Moscow, Beijing has sharpened its use of bilateral loans as a means of boosting its leverage over other nations. In Pakistan, Beijing has built its soft power by providing emergency economic assistance to Islamabad as it deals with a balance-of-payments crisis.[18] In Sri Lanka, Beijing assumed control of the Chinese-built Port of Hambantota for ninety-nine years after Sri Lankan found debt payments increasingly onerous, granting it a strategic position at a critical military and economic juncture in South Asia.[19] Across developing markets, China has followed a

12 Darya Korsunskaya, et al., "Russia's Top Banks Plot Temporary Sanctions Workaround: Sources," Reuters, Mar 14, 2019, https://www.reuters.com/article/us-russia-banks-accounts/russias-top-banks-plot-temporary-sanctions-workaround-sources-idUSKCN1QV22K.

13 Kathrin Hills, "Visa and MasterCard Restart Payments for Russian Banks," *Financial Times*, March 23, 2014, https://www.ft.com/content/006609bc-b2b4-11e3-8038-00144feabdc0.

14 Tatiana Voronova and Gabrielle Tetrault-Farber, "Mir Card Payment System Looks Beyond Russia," Reuters, April 19, 2019, https://www.reuters.com/article/us-russia-cards/mir-card-payment-system-looks-beyond-russia-idUSKCN1RV0KZ#:~:text=Now%20the%20country%20is%20hoping,told%20Reuters%20in%20an%20interview; Megan Davies, "Russia's Card Plan Seen Unlikely to Replicate China's UnionPay," Reuters, April 4, 2014, https://www.reuters.com/article/us-russia-cardsystem/russias-card-plan-seen-unlikely-to-replicate-chinas-unionpay-idUSBREA3310Q20140404.

15 Don Weinland and Gabriel Wildau, "China's Fight With Visa and MasterCard Goes Global," *Financial Times*, April 23, 2017, https://www.ft.com/content/a67350fa-1f6f-11e7-a454-ab04428977f9.

16 Maximilian Hess, "Bond of War: Russian Geoeconomics in Ukraine's Sovereign Debt Restructuring," Foreign Policy Research Institute, September 19, 2018, https://www.fpri.org/article/2018/09/bond-of-war-russian-geo-economics-in-ukraines-sovereign-debt-restructuring/.

17 "Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors," International Monetary Fund, December 8, 2015, https://www.imf.org/external/np/pp/eng/2015/101515.pdf.

18 Farhan Bokhari and Kiran Stacey, "Pakistan Seeks More Loans from China to Avert Currency Crisis," *Financial Times*, July 5, 2018, https://www.ft.com/content/1256ceaa-802c-11e8-bc55-50daf11b720d.

19 Jonathan E. Hillman, "Game of Loans: How China Bought Hambantota," Center for Strategic and International Studies, April 2, 2018, https://www.csis.org/analysis/game-loans-how-china-bought-hambantota.

playbook of lending that is, at best, opportunistic and, at worst, intentionally predatory.

In this regard, not only is the West "leading from behind," it may arguably not even be leading anymore. In the post-Cold War period, global energy markets have followed a similar trend of politicization, a trend that stalled in the aftermath of the price declines of the 1980s. Through the state-owned behemoth, Gazprom, the Kremlin has used its natural-gas exports to bully Eastern Europe and buy Western Europe's silence. Prior to the price declines of 2014 and onward, China's resource quest abroad focused heavily on securing energy reserves for the benefit of the country's burgeoning middle class.The dollar is the fulcrum around which the global oil market shifts and operates, with most of the international oil trade priced in greenbacks. The denomination of the oil trade has conferred significant advantages to Washington, as it seeks to sanction rogue actors like Iran, yet the long-term decline of oil over the next few decades may cause this tool to become less effective. In the EV space, China has invested heavily at home and abroad in developing mineral resources critical to this industry of the future. Meanwhile, Russia has built a name for itself in both the export of infrastructure and know-how for nuclear power. Not only will Washington's geoeconomic advantages wane, but those of rival states will increase.

The dollar's role in the international financial system has been complemented by rules, regulations, and arrangements that possess significant diplomatic externalities. Many are well known, like the Bretton Woods agreement, which pegged the dollar to a fixed exchange rate with gold, or the Plaza Accord, which negotiated a depreciation of the dollar's value in the 1980s to reduce Washington's trade deficit.

Yet, even the more esoteric parts of transnational financial regulations are increasingly shaping the global landscape of finance—for instance, the Basel Accords. First negotiated in the 1980s, the Basel Accords stipulate tolerable risk levels in banks, contributing to the demand for liquid financial assets. Its latest installment, Basel III, has added new capital surcharges to the world's largest banks. In placing these measurement dates at the end of each year, it ensured there are now new shifts in global markets occurring at those times, changing liquidity expectations for all market participants, including foreign buyers of Treasury bonds, who have previously financed much of Washington's deficits, as well as the borrowing binge of the American private sector.[20]

E) Moving Forward

In tandem with the shifts in the global economic order, the sanctions landscape is changing and, in some cases, has already changed. China's rise as an external creditor, the emergence of sovereign wealth funds, the growing potential for central banks to be used to evade sanctions, and the changing state of global regulations have all created a new background landscape for Washington's sanctions architecture.There is a strong chance of a bilateral sanctions dispute escalating into what could very well become a global financial standoff. A precarious situation like this could fizzle into obscurity or escalate into a new financial crisis, based on the decisions of Washington's policymakers. As long as the United States still approaches the table with the wrong playbook, the country's rivals, new and old—from malignant cyber threats to distant terrorist entities to emerging regional powers—will continue to hold the upper hand.

In this environment, sanctions are far from the antidote to all of Washington's problems. In spite of potential future adaptations, it is simply a statement of fact that Washington had grown addicted to the use of sanctions, at the expense of other—possibly more effective—policy options. Sanctions on their own do not constitute a strategy and, worse, sanctions can often be ineffective when implemented as an isolated tactic. The future will need not only a radical rethinking of Washington's sanctions strategy, but also a new approach to the field of financial statecraft and diplomacy as a whole.

The emergence of the Chinese financial system in digital currencies and Beijing's model of political economy have already fundamentally rewritten the rules of global order in ways that are just now being studied. In the same way that China's 2001 entry into the World Trade Organization catalyzed massive shifts in US manufacturing supply chains, China now threatens to become the dominant global tech superpower, with wide-ranging consequences. Already, Huawei's dominance of the 5G market through native innovation, rather than intellectual-property (IP) theft, has caused Washington to clash with many of its closest allies, like the United Kingdom (UK) and Germany. Regardless of the ultimate fate of China and its role in the global economy, the shifts currently under way will affect all aspects of US economic interactions, including Washington's sanctions policy.

20 Izabella Kaminska, "Don't Fear the Year-End Funding Squeeze," *Financial Times Alphaville*, January 29, 2019, http://ftalphaville.ft.com/2019/01/29/1548762302000/Don-t-fear-the-year-end-funding-squeeze/.

Part IV: The Dollar Used Against Iran

In this respect, contemporary commentary on sanctions has often looked at the case of Iran, lasting from 2006 through 2014, as a gold-standard model to be emulated. From the author's own experience, this is not incorrect: the Iran sanctions were an almost-perfect exercise in how sanctions should be formulated. First and foremost, they enjoyed broad bipartisan investment at home. This was evidenced by near-unanimous Senate votes on key bills, like the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA) of 2010, which laid the groundwork for an even-stronger multilateral process internationally.[21] This process not only had the effect of bringing in traditional US allies in Europe, who took politically challenging—but ultimately rewarding—steps, like instituting an embargo of Iranian oil and enforcing tough US financial sanctions. This also occurred in new emerging markets like India and China, through an innovative waiver system that enabled these players to reduce Iranian oil purchases, with liability waived on the remainder. In other words, if these governments credibly proved they were reducing purchases, they would still be allowed to purchase Iranian crude oil.

At the time, Washington's pressure campaign against Iran embraced not only sanctions, but a variety of tools, including diplomatic, military, and even innovative cyber pressure on Iran. Within this framework, sanctions were a means to an end goal: forcing Tehran to the negotiating table. While the Iran deal, the end result of this pressure campaign, did little to combat Iran's aggressive behavior abroad or its authoritarian regime domestically, the deal's purpose was never to touch on these purposes. There were flaws in the deal, but in regard to its objective (i.e., ensuring that Iran would not proliferate), it was successful in the short period of time during which it was implemented.

Closing this deal was no easy feat; the author personally met with European stakeholders on many of the toughest issues in the enforcement process. In particular, mid-sized European banks, in tandem with strong European demand for energy imports, profited heavily from their trade-finance relationships with Iran. Unlike the United States, where the sanctions-enforcement process is bolstered by powerful institutions, like the Treasury's Office of Foreign Assets Control (OFAC), Office of Intelligence and Analysis (OIA), and Financial Crimes Enforcement Network (FinCEN), Brussels lacks comparable institutions for the enforcement of its sanctions policy. In the author's meetings with European officials and firms, he always had to stress that these banks had a stark choice to make between access to the world's deepest and most liquid markets and their side businesses with Iran.

Once the economic cost of their political decision was made clear, it was easy for these banks to decide where they stood. At the heart of these negotiations, New York, the dollar, and Wall Street took precedence over Washington, DC, the F-35, and the Pentagon, forcing major firms to make a choice. Either they could seek to do business with sanctioned actors in Iran, giving them a small slice of a niche market, or they could interact in the world's most liquid and sophisticated financial markets contained within the dollar's ecosystem, but they could not do both. For the vast majority of firms, this was one of the simplest decisions they could have made.

21 Mark Dubowitz and Annie Fixler, "SWIFT Warfare: Power, Blowback, and Hardening American Defenses," Foundation for the Defense of Democracies, July 2015, https://s3.us-east-2.amazonaws.com/defenddemocracy/uploads/publications/Cyber_Enabled_Swift.pdf.

Part V: The Role of the Dollar in Great-Power Competition

As the United States now confronts an era of great-power competition, not only will this decision-making process become murkier for private-sector players, but also for the policymakers at the Treasury and State Departments responsible for designing and enforcing sanctions policy. China, in particular, with a voracious market of more than one billion consumers and the sheer size of its largest banks, represents a threat in this respect.

China

The economic rise of China has been anything but predictable, beginning in the early years following the death of Mao Zedong. After Mao's death, Deng Xiaoping, an enterprising reformer, took the reins of a state marred by internecine conflict. When he took charge in the late 1970s, Deng's immediate challenge was pressing forward with economic reforms that clashed with party hardliners, led by Chen Yun.[22] While Deng sought to bolster China's economic standing, he had no fantasies of political liberalization outside of those stabilizations needed to maintain the supremacy of the Communist Party (e.g., an emphasis on consensus among high-ranking officials in the formation of state policy). As China grew, Deng's position on political liberalization led him into conflict not only with the country's hardliners, but also its liberals, finally culminating in the disastrous events of Tiananmen Square. In other words, he only made political concessions if they boosted China's economic performance.

During this time period, China's unique mixture of market-driven decisions and state-driven decisions gave rise to an unusual official financial system. Between 1979 and 1984, four major banks were carved out of the central bank: Agricultural Bank of China, focused on lending to farms; China Construction Bank, focused on real-estate lending; Bank of China, focused on foreign exchange; and Industrial & Commercial Bank of China, focused on lending to industrial enterprises.[23] In spite of Deng's transformative policymaking in the early part of China's reforms, the State Planning Commission (SPC) remained the single largest influencer of the financial industry through its publication of Five-Year Plans. When the SPC created a new Five-Year Plan, financial resources at these banks, known as the Big Four, would be dedicated to the state's specified objectives, with no further questions asked.

In the present, the SPC has been supplanted by the National Development & Reform Commission (NDRC), which, while still in charge of managing China's Five-Year Plans, has ceded large swaths of regulatory authority to the Ministry of Finance and the People's Bank of China (PBOC).[24] But, in the early days of China's reforms, the SPC's de facto and de jure political power over the financial system would culminate in periodic bouts of inflation, driven by exuberant lending activity, which challenged the PBOC's mandate as the country's central bank. At the official administrative level, the SPC often superseded the PBOC institutionally, contributing to high price volatility. When inflation rose as banks extended more loans in the economy, the PBOC enacted sharp credit quotas in 1985, but as inflation subsided, these credit quotas would be challenged by the demands of the SPC's annual planning mechanism. In 1978, Chinese inflation measured only 0.7 percent, but it would hit 7.5 percent, 9.3 percent, and 18.8 percent in 1980, 1985, and 1988, respectively.[25]

As Deng's transformative economic reforms altered and rewrote China's political economy, the climb in inflation catalyzed greater social unrest, including the Tiananmen Square protests, which were tied, in part, to rising prices under the Dengist reforms of the 1980s. Another byproduct of heavy lending to state-owned enterprises (SOEs) in line with the SPC's Five-Year Plans was a consistent increase in non-performing loans (NPLs) on the balance sheets of the Big Four. When banks extend credit to the private sector, there is always some risk that borrowers will not repay their debts: a condition known as default. Loans that are close to or in default will be reclassified as NPLs on banks' balance sheets, separating them from loans that are providing steady streams of cash. When a bank accumulates too many NPLs, it risks going into default or, more commonly, becoming a "zombie bank": an insolvent institution reliant on government or central-bank intervention to continue operating.

The inflation dynamic shifted in the early 1990s, as the rate sank to 3.1 percent in 1990, with bank balance sheets strengthened by the establishment of separate policy

22 Stephen Bell and Hui Feng, *The Rise of the People's Bank of China: The Politics of Institutional Change* (Cambridge, MA: Harvard University Press, 2013).

23 Ibid.

24 Ibid.

25 Ibid.

banks in 1994.[26] These policy banks—China Development Bank (CDB), China Export-Import Bank (Ex-Im Bank), and Agricultural Development Bank of China—channeled official funds on behalf of the government. In spite of these developments, legacy SOE lending remained on the balance sheets of the Big Four, with NPLs comprising 30–50 percent of outstanding loans in the Chinese economy by the end of the Asian financial crisis.[27]

Though virtually all of Asia saw a rise in NPLs after this crisis, the closed capital account insulated the Chinese economy from the impact of the crisis, compounded by the critical choice not to devalue the renminbi (RMB). The undeveloped state of Chinese credit markets implied that non-performing only referred to loans by length of delinquency, as opposed to underlying financial characteristics. Specifically, NPLs only referred to loans delinquent for more than one year, not only understating the size of NPLs in the Chinese economy, but also spawning the growth of zombie loans to pay off delinquent obligations. Through the 1990s, more than 80 percent of new credit was channeled to SOEs.[28]

By 1994, the Big Four were technically insolvent, with 240.5 billion yuan of capital and more than 530 billion yuan in NPLs.[29] In the same year, state leadership explored the potential for debt-to-equity swaps as a relief tool, but the first steps to recapitalizing the banks would come four years later. In 1998, the Ministry of Finance injected 270 billion yuan of liquidity into the Big Four to bring their capital adequacy ratios to the Basel-recommended level of 8 percent.[30] The Basel Accords, a series of international financial-stability regulations governs how much risk large institutions can take on, and, in doing so, avoid the collapse of large, globally connected banks. Despite these state-mandated boosts, the NPLs would prove to be a continuing challenge for the banks, eventually triggering the State Council to authorize the creation of four asset-management companies (AMCs) in 1999.[31]

The AMCs should be considered a useful case in the development of future sanctions regimes against the Chinese state. Originally established to handle the disposal of NPLs from the Big Four, the AMCs have since acquired subsidiaries, developed new lines of business, and, in the case of Huarong and Cinda, pursued listings in Hong Kong. Each of the AMCs was created to process NPLs from a specific bank: Cinda was paired with the China Construction Bank (CCB), Huarong with the Industrial and Commercial Bank of China (ICBC), Great Wall with the Agricultural Bank of China (ABC), and China Orient with the Bank of China (BOC).[32]

One can think of AMCs as landfills for the worst assets on the Big Four's books. In essence, the continued presence of delinquent loans on the Big Four's balance sheets not only impeded the pace of their future lending to productive sectors of the economy, but also thrust into question their own financial strengths. The net effect of removing these assets and placing them into new institutions was the Big Four becoming (or seeming to become) financially healthier and, therefore, more active players both in China's real economy and in its capital markets. In popular parlance, this strategy is often referred to as the "bad bank strategy," whereby the holders of bad assets, in this case the AMCs, are bad banks in comparison to the "good banks" of the Big Four.

In their first move in 1999, the AMCs accumulated 1.4 trillion RMB ($170 billion) from the Big Four and China Development Bank. As WTO entry loomed on the horizon, Premier Zhu Rongji planned on disposing the nonperforming assets of the country's largest banks as a means of ensuring their successful listings in Hong Kong. He would have to adjust China's financial system in order to gain respect on the international stage. After courting strategic investors for these initial public offerings (IPOs), the Hong Kong listings would bring discipline to the state-owned commercial banks' (SOCBs') corporate governance, imposed by their foreign shareholders. As Hong Kong's stock markets were more developed than the mainland's, sophisticated investors could place pressure on these institutions to run more efficiently, in the same manner as other publicly traded companies. With IPOs slated for 2005, the government injected another 370 billion yuan into CCB and BOC in 2003.

These injections were followed up in 2004 by a second round of NPL purchases, with Cinda leading the way. Funded entirely by a loan from the PBOC, Cinda bought $5 billion of loans from Bank of Communications (BoCom) at 50 percent of face value, promising a recovery rate of between 30 and 40 percent. By contrast, in 1999, these loan transactions had occurred at face value, well above their true market value. Cinda, whose loans were primarily

26 Ibid.

27 Ibid.

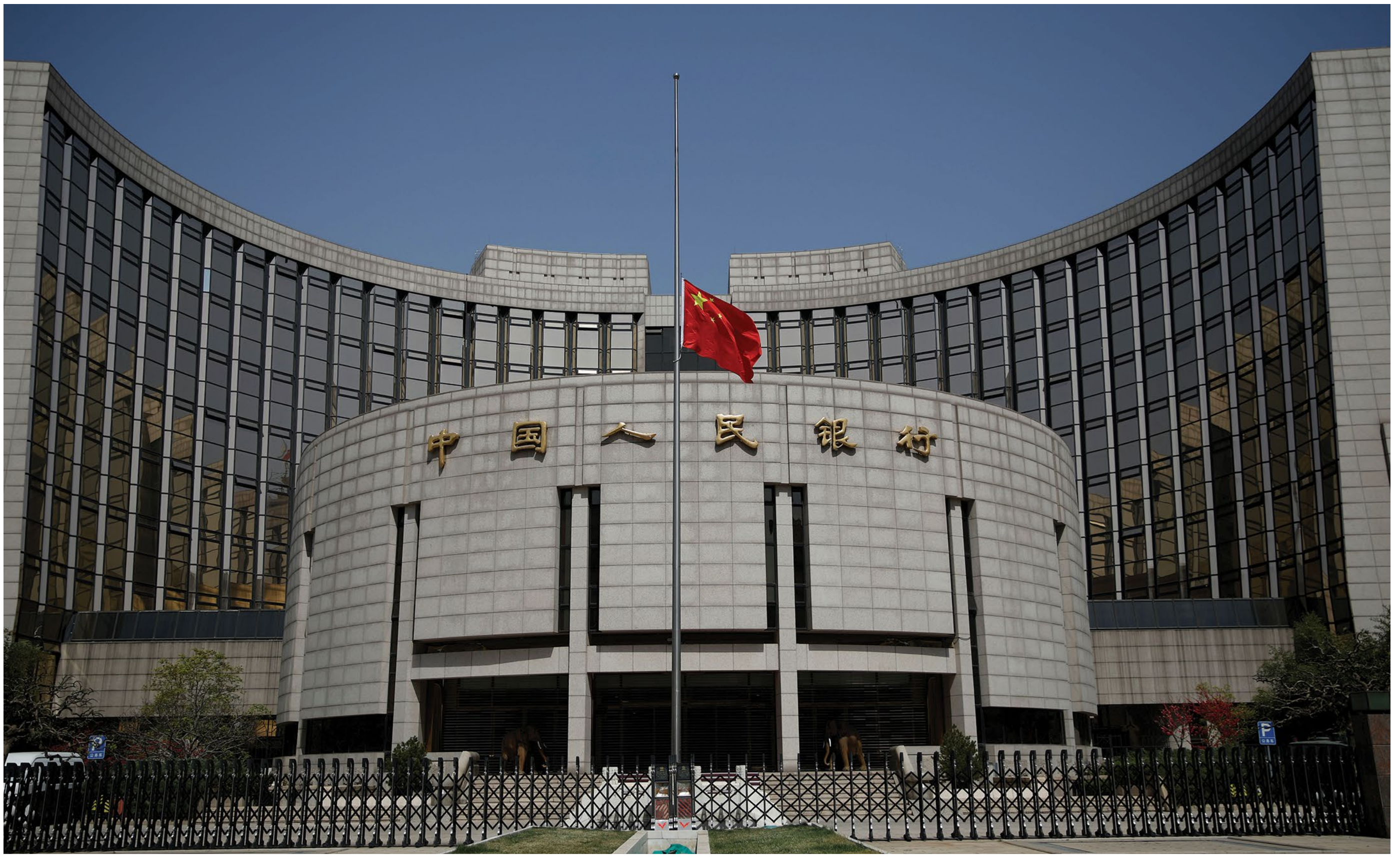
28 Ibid.

29 Ibid.

30 YK Mo, "A Review of Recent Banking Reforms in China," Bank of International Settlements, 1998, https://www.bis.org/publ/plcy07d.pdf.

31 Daniel H. Rosen and Logan Wright, "Credit and Credibility: Risks to China's Economic Resilience," Center for Strategic and International Studies, October 3, 2018, https://www.csis.org/analysis/credit-and-credibility-risks-chinas-economic-resilience.

32 Guonan Ma and Ben S C. Fung, "China's Asset Management Corporations," Bank of International Settlements, August 1, 2002, https://www.bis.org/publ/work115.htm.



The Chinese national flag flies at half-mast at the headquarters of the People's Bank of China, the central bank (PBOC), as China holds a national mourning for those who died of the coronavirus disease (COVID-19), on the Qingming tomb-sweeping festival in Beijing, China April 4, 2020. *REUTERS/Carlos Garcia Rawlins*

tied to the real-estate portfolios of CCB, had the highest recovery rate at 38.3 percent, compared to Great Wall, the lowest, at only 14.4 percent.

Through year-end 2004, the aggregate cash recovery rate of 20.3 percent challenged the AMCs' ability to effectively dispose of the NPLs in the Chinese banking system. To finance the initial NPL investments, these entities had borrowed 570 billion yuan from the central bank and sold 820 billion yuan in bonds to the Big Four. These bonds, held by China's major banks, were to be paid for with collections on delinquent borrowers' loans, which, if insufficient, could export the AMCs' problems back to the banks, leaving the situation unresolved. Instead of achieving a lasting solution to the mountain of NPLs in the economy, Beijing risked having simply delayed the inevitable with the creation of the AMCs; decisive action would need to be taken to support the financial system in a situation like this.

As was the case with the Big Four, the state stepped in once again to backstop the AMCs. In 2010, bonds due to mature ten years since the restructuring were extended for another decade by the Ministry of Finance, to buy time for the AMCs. At Cinda specifically, non-performing assets and liabilities were marked down to market value, allowing the firm to dispose of the burden of legacy loans and boost its profits. Normally speaking, when investors buy distressed loans, they purchase these at a discount from their full value, accounting for the heightened risk associated with the borrower's delinquency. Since the role of the AMCs was to recapitalize the banks, purchases at a discount would cause the banks to record losses, so the AMCs purchased the loans at their full value, in spite of the possibility of collecting the full obligation out of borrowers being very, very slim. By marking down to market value, Cinda disposed of these propped-up valuations, allowing for more serious collection efforts to take place, targeting borrowers' capacity to repay fractions of their stated obligations.

Since these steps were taken, the AMCs have followed the trajectory of China's banks and built themselves into formidable titans of capital markets. Cinda, the first to list on the Hong Kong Stock Exchange, was reorganized into a joint-stock company in 2010, before raising $2.5 billion from its international IPO. Drawing in strategic investors, 16.5 percent of ownership was transferred to China's National Social Security Fund, CITIC Capital, UBS, and Standard Chartered. The Ministry of Finance remained the largest shareholder in

Cinda, but its strategic investors anchored the IPO and were locked into their equity investments for three years.

In 2015, Cinda was joined by Huarong, which raised $2.3 billion from its Hong Kong IPO, and set a record for the role played by cornerstone investors. Key SOEs, including Sino-Ocean Land ($680 million) and State Grid ($300 million), bought stakes in the IPO, but were preceded by the 2014 sale of a 20-percent stake to Warburg Pincus, Goldman Sachs, and Khazanah Nasional, Malaysia's sovereign wealth fund.[33] The role of SOEs flipped the restructurings on their head, as, in addition to the SOCBs, the AMCs had played a key role in reducing the financial burdens of China's debt-beleaguered SOEs.

Once the delinquent SOE debt entered AMCs' books, it was reorganized into debt-for-equity swaps, converting the fixed liabilities of the SOEs' obligations into financial stakes in their futures. These SOEs, unshackled from their debts, were then able to grow significantly, with many pursuing overseas listings like their cousins in the financial industry. For the AMCs, these debt-for-equity swaps proved quite profitable in many cases, but in others, they appear to have had little impact on the profitability of the underlying SOEs.

Here, with the recapitalization of the country's largest banks, is where the narrative of the modern Chinese financial system begins. In the ensuing period, as China's GDP has grown tenfold from $1.2 trillion to $12.8 trillion, the financial system has ballooned twenty-twofold from $1.7 trillion to $38.4 trillion.[34] For policymakers at Treasury, this rapid growth introduces new risks into the sanctions equation than were otherwise present. Now, the sheer size and importance of the Chinese financial system brings into question whether sanctions are even an appropriate tool, considering the potential collateral damage to the global economy that could result. These types of challenges will likely be at the heart of targeting not only China, but other near-peer competitors as well. One has to question whether a deal like the Iran deal is still feasible in this new world.

Russia

This question pertains not only to China, but also to other rising powers. For example, as the United States was designing the Russia sanctions regime, it became apparent that the Iran playbook could not be used in the same way. From Washington's perspective, bilateral trade flows were minuscule, but Russia had a strong reliance on access to the Western financial system. To Brussels, however, the calculation was different: Europe's hunger for energy imports necessitated not only a strategic relationship between the Kremlin and the EU, but a strong and vital role in the continent's energy mix. As a result, an embargo similar to the one against Iran was off the table from the start.

As a consequence, it became harder to sell a strategy of restricting Russia's access to the Western financial system. Within the Kremlin's political economy, arguably the key variable is the capital flow from London and New York into Russia; these are particularly vulnerable streams of money, as they enable Putin's inner circle and even Putin himself to store wealth in secret accounts overseas. Targeting these flows was not only more technically challenging than the Iran financial sanctions, but also more politically difficult. The end result was a powerful sanctions regime unlike any the United States had constructed in the past or has levered since.

Each day, in the author's discussions with the teams at the Treasury and State Departments, the construction of the Russia sanctions felt like innovation in financial warfare. Knowing that the United States could not target correspondent access (and, as a result, access to international financial-messaging bodies like the Society for Worldwide Interbank Financial Telecommunications (SWIFT) either) or the energy trade, the United States resorted to a two-fold set of financial and sectoral sanctions. First, large Russian corporations would be banned from financing in euro- or dollar-denominated debt and equity markets. Next, Russian aerospace and energy firms were slapped with export controls targeting sensitive technology exports, including improvements in drilling technology related to fracking. Arguably, though, the greatest weapon that Washington had in its arsenal was the uncertainty of the market itself.

When the author walked back from his office in DC late at night, he could truly feel the difference between the Russia sanctions and the Iran sanctions: the United States was no longer just holding bad actors to account, but drawing up blueprints for full financial war. Iran was partly an exercise in this, but Russia post-annexation of Crimea was the most technologically intensive and politically sensitive sanctions regime the United States had carved to date (excluding North Korea). Ultimately, the Treasury's new sanctions regime was successfully implemented, but in it lay a number of key takeaways for addressing great powers in sanctions disputes.

Now, more than five years later, Russia remains in control of the Crimean Peninsula and continues its aggressive overseas activity. While sanctions were an important deterrent in ensuring that Russian ground troops did not move

33 Grace Zhu and Prudence Ho, "China Huarong Asset Management Lines Up Investors Ahead of IPO," *Wall Street Journal*, August 28, 2014, https://www.wsj.com/articles/china-huarong-asset-management-lines-up-investors-ahead-of-ipo-1409199325.

34 Rosen and Wright, "Credit and Credibility."

outside of Crimea into the additional disputed territories, which was a possibility in the early stages of conflict, they were not effective enough to push the Russians out of their existing holdings. As a large country with a sizable footprint in the global economy, it was never going to be as simple as it had been with Iran to adjust the Kremlin's calculus. As the United States deployed its sanctions, it had no illusions that sanctions would be the only policy tool deployed, or that the Kremlin would suddenly forfeit what was effectively an existential gambit for Putin and his cronies.

Central to this approach was Russia's superior ability to stomach or, in some cases, mitigate the effects of the most powerful US sanctions. In escalating the stakes against Russian banks, Treasury realized that the United States would be unable to designate the entire jurisdiction under Section 311 of the Patriot Act, as had been done against Iran; this legal hurdle made the problem of targeting individual entities much harder. In Iran, Section 311's prohibition on dollar-denominated correspondent activity was first levied against individual banks, before being ratcheted up to the level of the central bank. The targeting of the central bank amounted to a targeting of the entire jurisdiction: no bank could operate dollar-denominated correspondent accounts anywhere in the state of Iran. Coupled with the ban on Iranian banks from the international financial-messaging service, SWIFT, the US sanctions were effectively a financial embargo of Iran.

In Russia, the negative externalities of a potential banking collapse, as well as Russia's ability to launch countersanctions (e.g., leveraging Europe's vulnerable energy sector), made such powerful sanctions politically impossible. Unable to target the entire jurisdiction, the United States concluded that even if individual banks were sanctioned, industry peers—and even the state itself—would not sit idly by. If one major bank lost its correspondent access, other major banks in the country would step in to support it, preventing Washington from targeting those banks with the closest ties to Putin's inside circle with correspondent bans. Further, if all of the major banks were forced to exit, there was the potential for the Central Bank of Russia to provide emergency correspondent access. In other words, the United States could not direct an economic attack against Russia's individuals banks because the Kremlin would politically motivate remaining banks to band together to resist the sanctions.

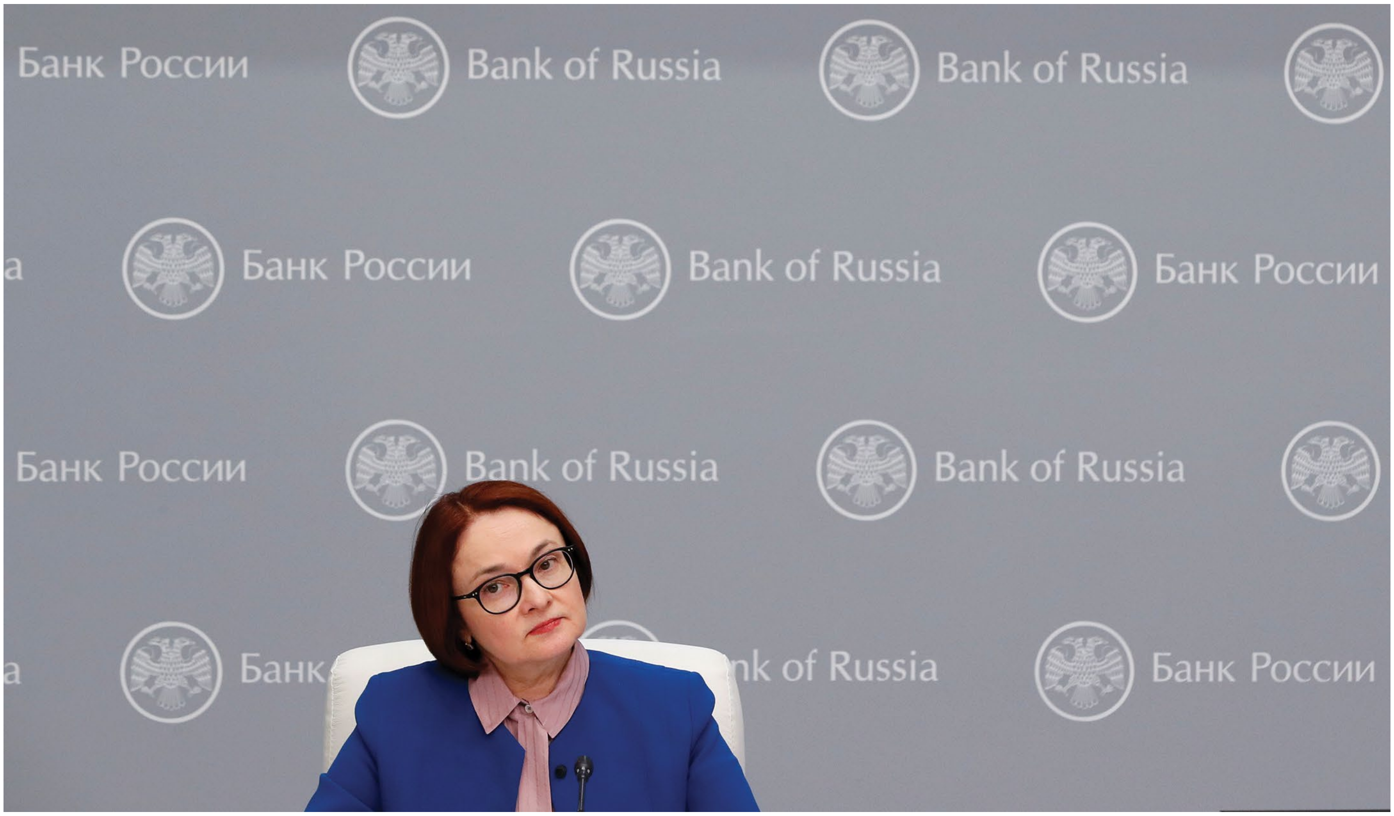
If the Kremlin pursued such action, the Treasury would face a catch-22 situation: if the central bank were not sanctioned, the sanctions, while having some effect on the business lines of banks, would be partially mitigated, but, if the central bank were sanctioned, there would be massive consequences. At the time, the Central Bank of Russia was a major holder of US government debt in the form of Treasuries. If the correspondent access of the Central Bank were shut off, other major holders of Treasuries could fear the same outcome. In the worst possible outcome, the targeting of the Central Bank could cause international players to question whether Washington was a responsible custodian of the international financial system, especially factoring in the potential stability consequences of sanctioning major Russian banks. The United States risked falling on a double-edged sword.

Implications

In China, the stakes will only be higher than they were in Russia, with the AMC model a demonstration of the kind of steps that Beijing would be willing to take to protect its financial system. Instead of isolating delinquent financial obligations, new institutions could be carved out, provided funding through what might be termed a "sanctions-resistant entity" like the People's Bank of China, and concentrating the sanctions risk of other actors in the economy. While the United States could target this new bank with sanctions, if it masked its customer relationships and received dollar funding from the government, it would be very difficult for the Treasury not only to craft an effective sanctions response, but also to enforce a sanction.

The Treasury already had to face a low-level case of this model being deployed during the Iran sanctions, in the form of Bank of Kunlun. Owned by China National Petroleum Corporation (CNPC)—one of the most powerful state-owned enterprises, better known by its Hong Kong-listed subsidiary, PetroChina—Bank of Kunlun continued to process payments in violation of US financial sanctions. The Central Bank of Iran held accounts at Kunlun that were used to process payments in the absence of access to other institutions. Via these accounts, funds were transferred to Chinese companies on behalf of Iranian companies, including firms identified as fronts for the Quds Force, an elite group within the Iranian Revolutionary Guard Corps (IRGC). At the time of Kunlun's sanctioning by the Treasury in 2012, Quds had been sanctioned by the United States since 2007 and the EU since 2011.

Kunlun was a case of the Chinese concentrating their payments with Iran into a single, small institution, thereby insulating the rest of the banking system from unintentional exposure to Iranian transactions. Given that Kunlun was a small bank that did not require extensive connections to dollar-denominated financial markets, the Treasury's sanctions against the firm were not as effective as they otherwise would have been. At the end of 2013, Kunlun reported having assets of 246.5 billion yuan, which has increased



Elvira Nabiullina, Governor of Russian Central Bank, attends a news conference in Moscow, Russia December 13, 2019. *REUTERS/Shamil Zhumatov*

to 317.5 billion yuan as of 2017, Kunlun's latest annual report.[35] While these sums are much smaller than China's major state-owned and private banks, they are not insignificant, and could be operated at a much larger scale in the future. Ideally, to target a firm like Kunlun, sanctions should go beyond just the entity itself and also challenge its owners—in this case, CNPC—but this entails higher costs to the United States. In a hypothetical scenario, in which the Chinese state divorced state-owned enterprises like CNPC from the process, and instead provided financing through a sanctions-resistant entity like the PBOC or Central Huijin, escalating sanctions would not only cause more harm to China, but also potentially to the globe, given the possibility for adverse effects on China's financial stability and, by extension, economic growth.

With Chinese authorities already struggling to adapt to a lower rate of growth as the country ages demographically and matures economically, sanctions could be an upset not only for Communist Party apparatchiks, but multinationals, international asset allocators, and Chinese consumers themselves. In the case of Russia, the Treasury weaponized not only the tangible financial connections between Russian corporations and Western markets, but also the intangible weapon of market uncertainty. With sanctions raising uncertainty in a jurisdiction, international investors and asset allocators must make hard decisions about whether to invest in assets that are currently legal under sanctions, fearing what the effect of successful sanctions might be on all parts of the economy, from supermarkets to private-equity funds.

In China, while this could be a powerful asset of the United States, there is significant potential for it to run outside of the control of US authorities. The underdeveloped nature of Chinese capital markets results in an influx of participation from retail mom-and-pop investors, and too little participation from major institutional investors. These household investors often day trade, capturing short-term opportunities, but the lack of institutions, especially mutual funds, makes the stock market an unpopular choice for firms' funding needs. Given that firms have a choice between debt financing through bonds and loans, or equity through stock issuance, the Chinese market is often bank-centric, characterized by financing provided by bank loans.

This is in contrast to the securities-market-centric United States, which is characterized by stock and bond issuance. Given that markets are already volatile under normal

35 "2018 Annual Report," Bank of Kunlun Corporation Ltd., June 25, 2019, http://www.klb.cn/eklbank/resource/cms/2019/06/2019062515011632629.pdf.

circumstances, sanctions could be tantamount to pouring gasoline on a fire. Much like the country's SOEs (many of which are zombie companies only staying in business because their banks are willing to roll over their loans continuously), the Big Four and most major Chinese banks are seen as implicitly backed by the government. If Western sanctions were implemented, this would imply a government response, which could take many forms, similar to the AMC case, but also to the case of the Chinese government's intervention in the stock market in the summer of 2015.

As the Fourth Plenum pledged the party would continue market reforms and the PBOC cut its loan and deposit rates by forty and twenty-five basis points, respectively, a tide of retail overexuberance struck the Chinese stock market.[36] From July 1, 2014, to June 12, 2015, the Shanghai Stock Exchange Composite Index (SSECI) surged by 152 percent.[37] Much of this rise was attributable to the practice of margin financing, by which investment is financed through additional leverage. By December 2014, the China Securities Regulatory Commission (CSRC), China's equivalent regulator to the Securities and Exchange Commission in the United States, began investigating these practices, concerned with those tactics that permitted retail investors to margin finance brokers. The principal targets were fund-matching companies, which provided unregulated margin loans to brokers, and umbrella trusts, obtaining funds from retail investors in wealth-management products (WMPs) to finance brokerages.

Normally, retail investors would not have access to such a complex market, but in China, this was not the case. Beijing launched a high-octane, interagency plan to support the country's stock markets, which appeared to be in virtually non-stop freefall. While bear markets can come and go in the United States with few political repercussions, this situation was anathema to the social contract of the party. In exchange for the surrender of political expression, China's burgeoning middle class was to be comforted with economic advancement. To see an untrammeled decline in the country's stock market decimate the middle class' physical savings and intangible consumer sentiment would be unacceptable to both the Communist Party and the people. Economic instability would upset political order.

By July 4, Li Keqiang had convened a meeting of the State Council, including a host of regulatory agencies, mutual funds, and brokerages. The twenty-one brokerages present formed a 120-billion yuan plan to purchase blue-chip stocks, and were barred from selling so long as the SSECI remained below 4500 points.[38] Later that week, two shadowy, quasi-state bodies, the China Securities Finance Corporation (CSF) and Central Huijin Investment (Central Huijin), began intervening into the country's stock markets.

Chinese authorities adopted a slew of ad-hoc regulations to stem the decline in the stock market. These regulations included the CSRC banning shareholders with greater than 5-percent ownership rights from selling stock to the China Insurance Regulatory Commission (CIRC), relaxing restrictions on insurance companies' investment in the stock market. Beyond the regulators, the state-owned Assets Supervision and Administration Committee (SASAC), responsible for administering China's mammoth network of SOE behemoths, barred SOEs from selling their equity holdings. Even at the private-sector level, the China Financial Futures Exchange hiked margins on CSI 300 futures from 20 percent to 30 percent, making it more expensive to short the CSI 300, an index of mainland stocks traded in Shanghai and Shenzhen.

By far most adept were the moves made by the CSF, Central Huijin, and their compatriots in what became known in popular parlance as "The National Team." The CSF and Central Huijin invested in 1,365 stocks, or 50 percent of the stock market, with the CSF providing an additional 260 billion yuan in margin financing to twenty-one brokerages to finance stock purchases. The PBOC itself pledged to provide the CSF with liquidity, while Central Huijin fell under the ownership of China Investment Corporation, the country's sovereign wealth fund, itself managed by the Ministry of Finance.

This episode certainly did not come without costs, as the Shanghai index fell 32 percent, and its counterpart in Shenzhen fell by 41 percent. All in all, the value lost in the Chinese stock market over this period amounted to 30 percent of Chinese GDP at the time, or 20 percent of US GDP, with more than 18 trillion yuan of market value wiped out on the Shanghai exchange.[39] The extensive involvement of the National Team raised firm value by between 2.4 and 3.4 trillion yuan, or 5 percent of Chinese GDP.

Six months later, the CSRC banned all securities companies from providing off-market or shadow lending practices. In the preceding week, the stock market fell 13.1 percent between June 15 and 19, its largest drop since 2008, with 2,312 of the 2,763 hitting the maximum decline of 10 percent

36 Yi Huang, Jianjun Miao, and Pengfei Wang, "Saving China's Stock Market," Boston University, last updated September 2016, http://people.bu.edu/miaoj/ChinaStockMarketAllfiles.pdf.

37 Ibid.

38 Ibid.

39 Ibid.

permitted by exchange authorities. By July 8, the SSECI had lost 32.1 percent, threatening not only the expendable retail investors, who had lost trillions of yuan, but also the balance sheets of China's largest banks and brokerages.

While sanctions against China's banks are unlikely to trigger a crash of a similar magnitude as Summer 2015's, the same institutions could be used to reduce China's exposure to sanctions. In the AMC model, China could concentrate sanctions-busting or sanctions-evading activity within a single institution, and then support it using sanctions-resistant actors. In the stock-market model, sanctions-resistant entities, like the CSF, Central Huijin, and the other members of the shadowy National Team, could provide support to sanctioned firms or institutions, in addition to actors like the PBOC, SASAC, or the National Social Security Fund, which would be tough for the United States to sanction.

In contrast even with Russia, China's regulators could also provide additional support to China's largest banks, if they were sanctioned. In the 2015 example, there was not only liquidity support from institutions like the CSF and Central Huijin, but also legal support from the CSRC and the Ministry of Public Security, both of which pursued investigations against short-sellers on the grounds of engaging in illegal conduct. While China's markets typically have weak enforcement procedures, it is generally accepted that these cases were, more often than not, cases of previously legal activity being investigated to provide support to important actors. If there were a selloff in the Chinese stock market, these types of investigations could be used as another channel to provide support to the market.

Of these institutions, Central Huijin should occupy the attention of the Treasury. Similar to the AMCs, Central Huijin was a creation of the bank recapitalizations in the late 1990s and early 2000s. After the Ministry of Finance's bailout in 1998 failed to stem the NPL problems, regulatory momentum had shifted to the PBOC by 2003. In the five years between, China's growing exports, by which China sold its product overseas, lifted its foreign-exchange (FX) reserves from $139.86 billion to $403.25 billion.[40] Having these funds in reserve, the PBOC saw the strategic opportunity to deploy them in support of the fragile banking system, through which the funds could be channeled.

Beginning in January 2004, the PBOC began injecting $45 billion in FX reserves into CCB and BOC to prepare for their planned IPOs in Hong Kong.[41] To handle these deployments of capital, the PBOC sponsored the creation of Central Huijin Investment, which functioned as the central bank's proxy. In exchange for the FX reserves, state-owned shares were concentrated in Central Huijin to facilitate management reforms. As it structured the CCB and BOC IPOs, Huijin wiped out the Ministry of Finance's stake by permitting the banks to place existing equity into a special-purpose fund to dispose of lingering NPLs.

Later, in 2005, Huijin's mandate was extended, as more than 90 percent of the country's savers faced losses from declines in the mainland stock markets. Authorizing the disbursement of $37.5 billion in capital injections, the State Council rubber stamped Huijin's recapitalization of the country's largest securities brokers, including Galaxy Securities, Guotai Junan, Shenyin Wanguo, and Southern Securities. As was the case with BOC and CCB, Huijin then used majority ownership to reform the brokers, inserting itself into the territory of the nominal securities-market regulator, the CSRC.

Functionally, Central Huijin's role had expanded the power of the PBOC, to the detriment of other authorities, including the China Banking Regulatory Commission, CSRC, and Ministry of Finance (MoF). After the destruction of its stakes in BOC and CCB, the MoF pursued joint investments in ABC and ICBC, as they prepared their own IPOs. By 2007, the tide shifted, as the Ministry of Finance received state support for the creation of a new sovereign wealth fund, the China Investment Corporation (CIC), which would be able to invest China's FX reserves in higher-yielding risk assets, as opposed to the traditional safe assets managed by the PBOC. In doing so, the ministry also received approval for its plan to merge Huijin with this newly created entity, returning it to a position of prominence in banking regulation, as Huijin managed the government's stake in the Big Four banks.

Returning to the sanctions scenario, if dollar access were curtailed to any of China's largest banks, like the Big Four, it would be second nature for China to stage a state intervention. There are broad precedents historically for states providing emergency liquidity support for their banking systems, including in the United States. In the lead-up to the 2008 financial crisis, foreign banks, in particular, were recipients of key swap lines from the Federal Reserve via their domestic central banks, in the interest of protecting the stability of the global financial system. The collapse of a major European bank due to its inability to fund its dollar assets could easily spread not only through the European financial system, but to the US system as well.

In extending these swap lines. the Federal Reserve leveraged its position as the printer of dollars: the global reserve currency. Many European firms, which received deposits from their customers in euros or pounds, needed to convert

40 Bell and Feng, *The Rise of the People's Bank of China*.

41 Ibid.

their local currencies into dollars if they sought to invest in dollar-denominated financial markets. For a consumer, it is practical to convert sums of money into foreign currency at a Travelex in a mall, or at a bank for larger sums of money. For a major multinational bank, however, the sums of money that need to be converted are so large that, assuming the supply of foreign currency for such transfers is available, the transaction costs eat into the bank's profits on these trades. As such, banks try to use efficient sources of financing, which led them to the currency swap market.

Even in a remote frontier market like Iran, there is still significant demand for dollars during periods of crisis. Just as multinational banks tapped the swaps market to buy dollars to invest in US assets, Iranian consumers typically resort to the black market to obtain dollars amid bouts of instability. In the author's time at Treasury, the money changers that serviced these markets offered key insights into the perspectives of the Iranian people: a vital asset in a country with limited outlets for free expression. Similar to how the price an Iranian consumer might pay at a black-market vendor for dollars increases when the United States announces new sanctions or Iran ratchets up its own rhetoric, the price at which multinationals borrow dollars via currency swaps can also fluctuate—often, for similar reasons.

As the 2008 global financial crisis deepened, market participants grew warier about extending dollars to foreign banks with investments in risky assets tied to the US mortgage market. The net effect was a rising swap rate that caused transaction costs to rise so high that banks faced the very real risk of losing money on their currency trades, in addition to the losses piling on their mortgage books, as borrowers' mortgage defaults picked up. This threatened the stability of these banks and, by extension, their trading partners, customers, and investments. The global economic order was in jeopardy.

The Federal Reserve responded to this by extending swap lines to major foreign central banks, including the Bank of England, European Central Bank, Bank of Japan, and Swiss National Bank, ensuring that their domestic banking sectors would have access to foreign currency to avoid a worsening of an already-deep financial crisis. As the printer of dollars, the Federal Reserve theoretically had access to an unlimited supply of dollars in a crisis, as it had the ability to continue printing dollars ad infinitum. The same would be true for the European Central Bank in regard to the production of euros, the Bank of England in regard to the production of pounds, and the PBOC in regard to the production of renminbi. While the value of these currencies could, in theory, fall as more supply was added to the market, there is no cap on how much supply can be added, if one is agnostic to the value of that currency.

Swap lines are not a development exclusive to the 2008 financial crisis, and, in fact, dollar swap lines can be extended by any central bank with sizable holdings of dollars. In fact, the PBOC has built extensive swap lines with foreign central banks that have contributed, albeit marginally, to Beijing's financial soft power. Today, the network of swap lines that undergird global central banks is a critical piece of financial infrastructure, especially in the case of a future financial crisis.

Were Chinese banks to be disconnected from the dollar, China's massive pile of dollar-denominated FX reserves could come to the rescue of the ailing Big Four, either through the PBOC or, more likely, Central Huijin. In the past, Chinese authorities have tapped the more than $3 trillion in FX reserves to support the policy banks, which were established to handle state-centric investment plans. In the initial stages of the Belt and Road Initiative, Beijing recapitalized the China Development Bank with $32 billion and China Export-Import Bank with $30 billion via entrusted loans that converted into equity.[42] China Development Bank, in particular, has been at the forefront of China's financial statecraft abroad, ranging from oil-for-loans deals in Venezuela to providing bilateral loans to the Pakistani government.[43] There is no reason to doubt that these same levers could be used to provide financial support to the Big Four in the event that they lose access to dollars, as well as the fact that the state could leverage its own correspondent access. In other words, traditional sanctions models won't work as a political weapon against China. And, "financial warfare," if waged against China, would threaten not only that target country, but the entire interconnected economic order.

As discussed, the underlying assumption on Chinese response models is that state apparatuses—including the central bank, the PBOC, and quasi-state actors including Central Huijin and Central Securities Finance corporation—are too large to be sanctioned. In the same way that major institutions like Goldman Sachs, AIG, and others were deemed "too big to fail" during the Great Recession, so too are these institutions too big to fail. If sanctioned, the consequences could be massive not only for the Chinese domestic banking system, but also for the overall health of the global economy. Were China's rate of economic growth to slow further as a result of these actions, one of the first areas to be hit would be the US stock market, where the

42 Gabriel Wildau, "China Backs Up Silk Road Ambitions With $62B Capital Injection," *Financial Times*, April 20, 2015, https://www.ft.com/content/0e73c028-e754-11e4-8e3f-00144feab7de.

43 Prudence Ho, "Venezuela Oil Loans Go Awry for China," *Wall Street Journal*, June 18, 2015, https://blogs.wsj.com/frontiers/2015/06/18/venezuela-oil-loans-go-awry-for-china/;"Pakistan Puts a Spotlight on China's Opaque Loans," *Financial Times*, August 1, 2018, https://www.ft.com/content/3e6f9ee8-9578-11e8-b67b-b8205561c3fe.

Chinese market plays a role not only as a key supplier, but also as a key consumer for certain industries.

Working under this assumption, there are two primary ways in which China could insulate itself from the risk of sanctions. The first is the “bad bank model”: in the same way that the AMCs, in the recapitalizations of the 2000s, concentrated the bank’s worst assets into their own portfolios, Beijing could arbitrarily create a new entity or designate an existing entity to hold a portfolio of assets that are exposed to sanctions risk. These assets could range from joint ventures with Iranian oil companies to bond deals with Russian banks to bank accounts with Congolese kleptocrats. Receiving funding exclusively from sanctions-resistant entities in the state, coupled with significant effort to hide their Chinese customers, could allow funds to continue to flow to bad actors in the Treasury Department’s crosshairs.

The second and more powerful of the two strategies for insulating China from sanctions is through state intervention to support financially weakened players. Under Section 311, the treasury secretary can prohibit the correspondent access of any financial institution, ranging from small consumer banks to the level of central banks. In utilizing this tool against major Chinese banks, the central bank of China could step in to provide correspondent access as a last resort, as well as deploy its FX reserves to support dollar-denominated transactions. In doing so, the Treasury would face a stark choice: sanctioning the largest foreign holder of Treasury bonds or enabling naked sanctions evasion. To prepare lawmakers, academics, and market participants for the banking wars of the future, the operating environment, strategic options, and potential responses to those options are laid out in the following chapters.

Part VI: Era of Digital Dollar and Digital Currencies

Adding another dimension to the conversation regarding international economic prowess is the evolution of digital payment systems, which have led to the global race for deployment of a central bank digital currency (CBDC). At this point in time, nearly 80 percent of central banks across the globe have engaged in work related to national digital currencies, according to an Atlantic Council report.[44] Though the advent of digital payment systems is not novel, the idea of a CBDC, issued by a central bank and backed one to one by the fiat currency, has opened new frontiers for financial diplomacy.

The Central Bank of China was one of the first to move in this space, assembling a special task force to conduct research on digital currencies and establishing the Research Institute of Digital Currency in 2014. China's goal in doing so was to promote the internationalization of the renminbi, which has largely stalled since 2015. China hopes that the digital renminbi can be used in cross-border payments without going through banking intermediaries, effectively avoiding the US financial system and leverage of US sanctions. Its regionally limited pilot program for the CBDC was rolled out in April, with anticipated widespread usage by the time that Beijing hosts the Winter Olympics in 2022.

Though some question the critical value of a CBDC, this platform varies from other forms of digital currencies because it eliminates the need for an intermediary role in the traditional system of "checks" made by a bank before a transaction is settled. In this new system, the digital yuan (which would be backed one to one by the paper yuan), would allow a direct exchange between the central bank and other parties, in a far more efficient process. While the possibilities for applications of this Chinese digital currency are wide ranging and begin to hint at the potential uses of AI in implementation, the world naturally seeks a response from a US administration that is less prepared for such a change. This shift—if it is rolled out before any answer from the United States—could hold great international importance as China utilizes its newfound "workaround" strategy to reduce the global significance of the greenback and US sanctions power. A key indicator for China's success moving forward will be how it leverages important Chinese companies like Tencent and Ant Financial, which already have more than one billion users each for their digital wallets, outside of China.

Through a comparison of the recently proposed bills in which the US Congress has addressed ambitions to transition to widespread use of a digital dollar, and the critical research that China has reportedly been conducting on the rollout of its own digital renminbi, it is reasonable to conclude that the United States is behind in its capabilities to create and utilize a CBDC. While the Chinese government possesses the unique ability of an authoritarian system to put incredible emphasis on a problem and set its population to work determining a working solution, the United States struggles to find the same capacity to work this way within its own economic sectors.

In the digital era, it is more important than ever for the United States to build partner capacity and long-standing relationships with private-sector talent in order to implement effective technological change. Unfortunately, these relationships have been few and far between in the recent past, and the US government may struggle to manufacture an effective, secure infrastructure for the digital dollar in coming years without them. Though some may be skeptical of a digital-currency future, the rise of China as an economic power, and its desire to build a competitive currency for the US dollar that may move the world to a basket of currencies, will likely influence US action.

44 *The Rise of Central Bank Digital Currencies*, Atlantic Council, June 16, 2020, https://www.atlanticcouncil.org/blogs/econographics/the-rise-of-central-bank-digital-currencies/.

Part VII: Outlook and Recommendations

As one reflects on the ways that the international monetary system has evolved since the time of the Bretton Woods agreement, a few aspects are most salient. For one, the US economy and the power of the dollar have largely been unmatched in their strength or performance over this time period. Though some countries have expressed concern about the existence of a global economy, hinging on the expectation of US financial stability, the power of the dollar has been reiterated time and time again through periods of crisis. With this privilege of great financial power, the United States has been able to leverage effective sanctions on rogue nations such as North Korea and Iran; however, some of the same strategies have not worked in relation to other critical global players.

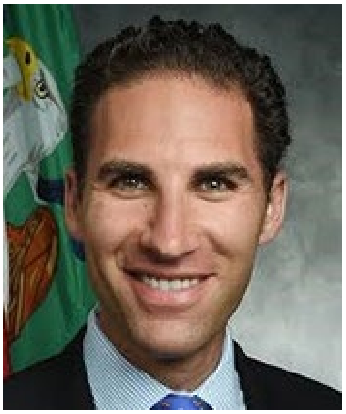
As the United States exits another crisis period in the age of the coronavirus, its position of leadership in the global economy has again been reinforced. However, as one looks at the long-term implications of another economic collapse and aspirations of other countries to decouple themselves from the power of the dollar, it is critical that the United States continue to look forward and prepare for the future. Just as the United States was quick to act in tracking terrorist financing and money laundering in the years following 9/11, it has been proactive in shoring up global markets against effects of the pandemic. However, when it comes to the advent of digital currencies, the United States has shown far less interest in developing its own viable system.

Through this extended discussion of financial authority, one has seen the wide-ranging impacts and privileges of the leader of a hegemonic system. In order to retain an leading role, the United States cannot allow the burgeoning economic power of China to seize control of the digital economic space. As the European Central Bank (ECB) and

China's official app for digital yuan is seen on a mobile phone placed in front of an image of the Chinese flag, in this illustration picture taken October 16, 2020. *REUTERS/Florence Lo/Illustration* other European countries establish working groups to figure out the viability and structure of a digital currency, the United States lags behind and risks the possibility of forcing partner nations to turn to China—just as they did in the case of fifth-generation (5G) technology.

In the coming months, it would be prudent for the United States to open a dialogue and join the working group established amongst European countries to build a viable digital currency. In building a cooperative effort toward this goal, the United States will be issuing a forward-facing, renewed approach in its commitment to partner nations. Ultimately, success in building this digital currency system will give the world an alternative to China's product. If the United States does not cooperate and work with partner nations, it risks a gradual unseating of its global financial leadership and the long-term rise of China to a position of significant economic authority in the international sphere. Since the United States has seen the wide-ranging impacts and significant influence that financial diplomacy can have on shaping the world order, a constantly evolving approach to competition with China and a renewed transatlantic partnership will be necessary to hold continued access to this vital tool.

About the Author



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