The Use and Misuse of Economic Statecraft

How Washington Is Abusing Its Financial Might

Jacob J. Lew and Richard Nephew

Since the end of the Cold War, the United States has come to rely more and more on economic tools to advance its foreign policy goals. Some of these tools, such as sanctions, involve the direct application of economic pressure. Others, such as the promotion of free trade and open markets, work by changing other countries' incentives. But all of them rest on a recognition that unrivaled economic power gives the United States a singular capacity to pursue its interests without resorting to force.

But economic power, like any tool, can have unfortunate results if wielded unwisely, producing unwanted short-term consequences and prompting the long-term decline of U.S. economic leadership. Today, Washington is increasingly using its economic power in aggressive and counterproductive ways, undermining its global position and thus its ability to act effectively in the future. Symptoms of the problem have been evident for years, but it has gotten markedly worse under the Trump administration, which has pursued reckless tariffs against both allies and rivals, reimposed sanctions on Iran without any pretense of international support, and acted in both cases with little evident regard for the negative consequences to U.S. interests.

Every policy presents a tradeoff. Yet U.S. officials seem to have adopted the belief that the United States is so large and powerful that the laws of

JACOB J. LEW is Visiting Professor of International and Public Affairs at the School of International and Public Affairs (SIPA) at Columbia University and a Partner at Lindsay Goldberg. He served as U.S. Treasury Secretary from 2013 to 2017.

RICHARD NEPHEW is Senior Research Scholar at SIPA's Center on Global Energy Policy and served as Deputy Coordinator for Sanctions Policy at the U.S. State Department from 2013 to 2015.

economic and political gravity no longer apply to it. According to this line of thinking, the country can start trade wars and no one will retaliate because, in the words of Peter Navarro, the director of the Trump administration's National Trade Council, "we are the most lucrative and biggest market in the world." The United States can threaten sanctions against its closest partners and allies, and they will somehow still cooperate, now and in the future. And it can continue to make poor economic choices, and the primacy of the U.S. dollar will somehow remain unchallenged.

But in an increasingly multipolar world, the economic influence that the United States has enjoyed since the end of World War II can no longer be taken for granted. And an aggressive or unilateral approach to economic statecraft—a dynamic that was evident at times across multiple administrations but that has reached an extreme under the current one—threatens that very influence. If the Trump administration continues down its current road, then it runs the risk not only of provoking global resistance that will thwart its immediate policy goals but also of reducing the United States' long-term leverage on the global stage. That outcome would be both tragic and ironic: U.S. policymakers, blinded by a belief in their country's unlimited power, will have accelerated its decline.

THE IMPORTANCE OF BEING PRUDENT

Economic statecraft—the use of economics as a tool of foreign policy—can take many forms. The best example is sanctions, which directly impose economic penalties on foreign countries or individuals for noneconomic reasons, but other types of economic policy can also be used for strategic ends. Trade, for example, is often used to gain international influence or pursue diplomatic goals. And as with military power, the tools of economic statecraft don't always have to be used to achieve their desired effect: sanctions sometimes work best when the mere threat of them prompts a concession.

Over the past three decades, globalization has increased the importance of good economic statecraft. Greater interconnectedness means that countries are now benefiting from opportunities around the world; at the same time, they are more exposed than ever to risks that flow from decisions made on the other side of the planet. This interconnectedness gives policymakers, especially those in a country as economically powerful as the United States, an important source of leverage. Thanks to globalization, foreign banks and companies will often comply with U.S. sanctions not because their own governments require it but because they wish to retain access to the U.S. market, dollar, and financial system, greatly magnifying the power of those sanctions.

Yet this advantage is not a license for the United States to do whatever it wants. There are risks and costs to economic statecraft, and using it properly is a careful balancing act. Before imposing sanctions, for instance, U.S. policymakers should consider whether the measures might violate trade agreements or other international obligations and, if so, whether the benefits will still outweigh the costs. They should be doubly cautious in cases where their actions could undermine fundamental U.S. interests, whether in the promotion of free trade, the creation of markets for U.S. goods and services, or the protection of institutions that facilitate global business and development. In fact, prudence and restraint are often cardinal virtues in U.S. economic statecraft, since radical changes may threaten the United States' current position of economic power.

KING OF THE HILL

Although sanctions and other forms of economic coercion had long been tools in the U.S. foreign policy arsenal, their use greatly expanded after the collapse of the Soviet Union, which left the United States with unprecedented economic and political power. According to the economists Gary Clyde Hufbauer, Jeffrey Schott, and Kimberly Ann Elliott, during the 1990s, Washington used some form of unilateral sanctions against 35 countries, up from 20 the previous decade. In some cases, including the U.S. sanctions against Iraq in 1990–91, Yugoslavia in 1991, and Rwanda in 1994, the United States worked with other countries in the UN Security Council to legitimize the measures. But if coordinated international pressure was unachievable or failed to convince a country to change its behavior, Washington did not hesitate to resort to more aggressive, unilateral measures.

The most important of these were what policymakers call "secondary sanctions." Regular, or "primary," sanctions bar U.S. citizens and firms from doing business with particular companies or individuals. Secondary sanctions, by contrast, prohibit Americans from doing business not only with sanctioned companies and people but also with any third parties dealing with them. If a bank in France made a loan to a company in Iran, for instance, Americans could be barred from dealing with that bank, even if the loan were legal under French law. The result would be to effectively shut the French bank out of the U.S. financial system. And because so many of the world's major companies are involved in the American financial system or conduct business in U.S. dollars, secondary sanctions give U.S. policymakers a far longer reach than they would otherwise enjoy.

Other countries often bristle at secondary sanctions, viewing them as a particularly brazen example of American unilateralism and an illegal, extraterritorial application of U.S. law. In 1996, Congress authorized the U.S. government to sanction foreign companies for doing business with Cuba or for investing in the Iranian or Libyan oil sectors. The EU responded by accusing Washington of violating both European sovereignty and international law, initiating proceedings against the United States at the World Trade Organization (WTO), and passing legislation prohibiting European firms from complying with U.S. sanctions against those countries. Tensions were defused only when the Clinton administration agreed not to enforce secondary sanctions against European companies in exchange for greater U.S.-European policy harmonization on Cuba, Iran, and Libya.

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After the 9/11 attacks, President George W. Bush took a more aggressive line as part of the war on terrorism, regularly asserting that the United States could impose penalties against companies and people that had no physical presence in the country yet did business in dollars or through U.S. financial institutions. In 2006, for instance, U.S. officials invoked an executive order concerning the proliferation of weapons of mass destruction (signed by Bush the year before) to warn foreign firms that they could be sanctioned for working with Iranian companies. And in 2010, in an effort to further punish Tehran for its nuclear program, Congress dramatically expanded secondary sanctions on foreign financial institutions doing business with Iran while limiting the president's authority to waive their enforcement.

European governments, among others, could have resisted these sanctions and complained about their enforcement, as they did in the 1990s. At the time, however, they were working closely with the United States to deal with the Iranian threat, including by tightening UN sanctions on Iran. The Europeans were therefore willing to cooperate with the United States in sanctions enforcement, leading many in Washington to believe that they had accepted secondary sanctions as a legitimate policy tool.

They had not. Although the Europeans agreed that Iran needed to be pressured, they continued to insist that the EU pass its own sanctions and that European companies follow European, not U.S., law. European officials continued to object, moreover, when Washington enforced its primary sanctions on European banks using the U.S. financial system to do business with sanctioned entities. In 2014, for example, the United States fined the French bank BNP Paribas nearly $9 billion for violating U.S. sanctions on Cuba, Iran, and Sudan, prompting accusations from Paris of "economic warfare" and an attempt by French President François Hollande to convince Washington to waive the fine. Europe's frustrations sent a clear signal: aggressive use of U.S. economic power can produce blowback, even from close allies.

Yet even as U.S. policymakers became more willing to assert global sanctioning authority during the Bush and Obama administrations, they understood the limits of confrontation. Consider how the Obama administration dealt with getting China to join the sanctions against Iran. True, the administration compelled China to reduce its purchases of Iranian oil and used secondary sanctions to punish myriad Chinese entities for doing business with Iran. But the administration picked its battles. Although China reduced its purchases of Iranian oil by less than the 20 percent that other countries did, Washington accepted China's contribution to the pressure campaign and declined to apply secondary sanctions against Chinese entities buying Iranian oil, since doing so could have undermined progress on other important bilateral issues or started a costly sanctions or trade war.

The Obama administration also chose to tread carefully when organizing sanctions against Russia in response to its invasion and annexation of the Crimean Peninsula in early 2014. Unlike China, Russia is not a global economic power, but it does have a great deal of leverage in Europe, particularly in the energy sector. Even today, the country is the EU's fourth-largest trading partner, and the Russian and European financial sectors are tightly linked, meaning that any damage done to financial institutions in Russia could easily spread to those in Europe, creating the risk of global contagion.

In deciding how to respond to Russian aggression, U.S. policymakers thus had to consider the interests of their European allies. When the United States and the EU finally agreed on sanctions, they carefully engineered them to concentrate pressure on the key decision-makers in Moscow while leaving Russia's energy exports to Europe intact. The early sanctions, enacted in the initial months of 2014, targeted influential individuals around Russian President Vladimir Putin and their preferred financial institution, Bank Rossiya. As Russia moved deeper into Ukraine throughout 2014, the campaign intensified, with the United States, the EU, and other allies passing new sanctions limiting Russian access to international debt and equity financing. Although the results of these sanctions were mixed—Russia did not withdraw from Ukraine, but it did suffer real economic pain and eventually came to the negotiating table—Washington managed to preserve a cooperative relationship with its allies.

To be sure, excessive deference to international concerns is not always a virtue. For example, the Obama administration could have—and in retrospect perhaps should have—pushed China earlier and harder to join in the international sanctions against North Korea. Believing that Pyongyang was still years away from developing a deliverable nuclear warhead, the White House limited its short-term pressure on Beijing over this issue in order to secure its cooperation in other areas, such as the negotiations with Iran over its nuclear program and the Paris agreement on climate change. Only once it became clear in 2016 that North Korea's nuclear and missile programs were advancing rapidly did the Obama administration increase pressure on China and win support in the UN Security Council for tougher international sanctions.

President Donald Trump, to his credit, has been more willing to squeeze China for concessions on North Korea. Through bellicose rhetoric and a tightened multilateral sanctions regime, he succeeded in convincing China to step up its enforcement of international sanctions on North Korea. It is doubtful whether the current U.S.–North Korean talks will go anywhere, but even so, Trump's high-risk approach helped drive North Korea to the negotiating table. A potential side effect, however, is that the Trump administration has learned the wrong lesson from its success: that the aggressive use of sanctions pressure always pays off.

PENNY WISE, DOLLAR FOOLISH

Although sanctions have been key instruments for the United States, they are not the only tools of U.S. economic statecraft. During the 1990s and the first decade of this century, the United States worked to remove trade barriers through both bilateral and multilateral agreements while strengthening institutions behind them, such as the WTO. In so doing, it expanded growth, encouraged developing countries to embrace free markets and open societies, and helped reduce global poverty.

Yet in its engagement with international institutions, as with sanctions, Washington's perception of its own invulnerability has at times undermined its interests. Even as it promoted free trade, the United States was gradually becoming a less reliable partner in funding the institutions that held up the global economic order. It fell into arrears at the UN in 1985, and its commitments to the World Bank and the International Monetary Fund have been in constant peril since the 1990s. Washington has historically been the main funder of the largest international financial institutions (IFIs)—the World Bank and the IMF—which has granted the United States powerful influence within them, including veto power over their major decisions. Although U.S. funding for those IFIs has remained sufficient to retain that veto power, it has been shrinking as a percentage of total new commitments.

Helping fund IFIs serves U.S. interests. By contributing to international financial stability, IFIs reduce the risk of crises that could damage the U.S. economy; by establishing common standards for financial behavior, they get emerging-market countries invested in the rules-based liberal order; and by distributing economic burdens, they allow the United States to pursue its interests at a reduced cost to itself, as was the case with the U.S.-led IMF campaign to stabilize Ukraine's economy in the face of Russian aggression. But when Washington does not pay its bills or prevents the institutions from giving greater voice to emerging-market countries, it limits its own ability to project power.

The IMF is a case in point. Since the 1990s, its funding has been a source of fractious debates in Congress. In 1998, a bill to appropriate money for the fund passed thanks mainly to the bipartisan efforts of senators representing agricultural states, who saw the IMF as a means to maintain U.S. export markets abroad. And when the IMF attempted to enact reforms in 2008 and 2010 to replenish its capital after the global financial crisis, proposing a doubling of total member contributions and a greater vote share for developing countries, it took Congress until 2015 to approve the reforms. Frustrated by the long delay and their lack of influence within the organization, emerging-market countries responded by creating new multilateral institutions, such as the New Development Bank and the Asian Infrastructure Investment Bank.

U.S. leadership at the World Bank and IMF grants Washington enormous leverage. But although it has veto power in these institutions, it cannot automatically win support for its priorities within them. Doing so requires international consensus, which becomes harder to achieve the more that other countries think the United States is shirking its responsibilities. Washington supported IMF loans to Europe after the 2007–8 economic crisis, which reduced U.S. exposure to financial contagion, and to Iraq in 2004 and 2016, which helped the U.S. war effort by stabilizing the Iraqi economy. In both cases, IFIs bore much of the financial burden for policies important to the United States. Washington was able to win support for these efforts, but the longer its commitment to IFIs withers, the harder such support will be to obtain.

TRUMP'S WRONG TURN

Although international concerns about Washington's aggressive use of economic tools have been growing for decades, they have become even more acute under Trump. His administration is behaving as if the United States is immune to consequences, whether in the form of adversaries exerting economic pressure or allies rejecting the legitimacy of U.S. policy. This hubris is particularly evident in two areas: the administration's protectionist trade policy and its withdrawal from the Iran nuclear deal.

On trade, Trump got off to bad start by pulling out of the Trans-Pacific Partnership, a 12-nation free-trade agreement, during his first week in office. Matters have only gotten worse in 2018, as the United States has imposed tariffs on a wide range of imports, including aluminum, solar panels, steel, and washing machines. These have applied not only to rival states, such as China, but also to close allies, such as Canada, Mexico, and the EU. Although the United States can point to legitimate concerns, such as China's exporting of aluminum and steel at artificially low prices, Trump's policies are doing more harm than good. Other countries have responded with retaliatory tariffs against U.S. goods, from soybeans to Harley-Davidson motorcycles, but even more concerning than the economic costs is the damage that has been done to relations with allies. Moreover, Trump's tariffs, coming at the same time as his shift on Iran, have antagonized Washington's European allies, in particular, with leaders across the continent now calling for greater EU independence from the United States.

On Iran, Trump has also managed to undermine U.S. interests through bellicose, unilateral action. When Trump withdrew the United States from the Iran deal in May, he did so against the wishes of every other party to the agreement and despite all available evidence suggesting that Iran was complying with it. The administration then began reimposing U.S. sanctions and threatening to aggressively enforce secondary sanctions against companies whose governments have remained in the deal, including those of the United States' Asian and European allies.

Trump's decision has begun to seriously affect Iran's already shaky economy. Iranian oil exports have been dropping since April, and analysis by BMI Research estimates that the country's GDP will shrink by 4.3 percent in 2019. This should come as no surprise. Officials in the Obama administration often stated that U.S. sanctions, if reimposed, could damage the Iranian economy, notwithstanding the relief it had enjoyed under the Iran deal. But the point of sanctions is not simply to impose pain; it is to use this pain as part of a negotiating process, with the aim of getting policy concessions from the other side. Sanctions work only if other countries believe that they can obtain relief by changing their behavior. If a country bows to U.S. demands only for Washington to reimpose sanctions, as Trump has done with Iran, there is little incentive for compliance in the future.

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By going it alone and pulling out of the Iran deal, the United States has potentially failed in terms of both exerting pain and prompting concessions. Washington's closest European allies, such as France, Germany, and the United Kingdom, are now working directly with the Iranian government to find ways of diverting business away from the dollar-based financial system in order to avoid U.S. sanctions and keep the existing deal in place. In July, the remaining participants in the nuclear deal released a joint statement that included a lengthy list of efforts to block the enforcement of U.S. sanctions, such as maintaining financial channels with Iran, promoting trade and export credits, and encouraging European investment in the country. Even if these efforts fail in the short term, they could eventually lead to the development of new strategies for working around U.S. policy.

LOSING THE RACE

The outlook for U.S. economic statecraft, if it continues on its present trajectory, is bleak. When it comes to sanctions, other countries will likely soon begin challenging or ignoring measures that have been imposed by Washington without international support. The more that other countries are willing to cheat on sanctions or simply look the other way, the more the United States alone will have to shoulder the burden for monitoring and enforcing them. As more nations find means of avoiding enforcement, such as business structures that separate companies transacting with the United States from those transacting with sanctioned entities, U.S. sanctions will begin to lose their effectiveness. And if other countries band together to reject U.S. sanctions, Washington could find itself having to choose between enforcing against everyone and giving up on the sanctions.

Things will get even worse as the United States loses its dominant position in the global economy. Today, the country largely gets its way because there is no alternative to the dollar and no export market as attractive as the United States. But if Washington continues to force other nations to go along with policies that they consider both illegal and unwise, over the next 20 to 30 years, they are likely to shift away from the United States' economy and financial system. On a long enough timeline, the formation of alternative centers of economic power may be inevitable, but it would be foolish to accelerate this process and worse to make the United States toxic while doing so.

On trade, too, the United States faces a future of more, and possibly more unfair, competition. The current international economic system does not operate perfectly, but it does have rules against unfair trading practices and the means of enforcing them. Moreover, the system incentivizes all nations to obey the rules. China and Russia did not join the WTO simply for prestige; they also wanted to obtain the benefits that flow from membership, such as preferential tariff rates and a legal remedy against protectionism. If the United States abandons its role as the guarantor of this system, other countries may rewrite the rules of trade. They are unlikely to do so with U.S. interests in mind.

GETTING BACK ON TRACK

If Washington wants to maintain its economic leverage in the future, U.S. policymakers will have to temper the unilateral approach to economic statecraft that they have increasingly adopted since the end of the Cold War. To begin with, they must be honest with themselves about the limits of U.S. power and the tradeoffs that accompany any policy. The United States must protect its right to act unilaterally, and in some cases, it will make sense to pursue an aggressive line or act against the wishes of U.S. allies. But policymakers should do so in full knowledge of the potential consequences and only when truly necessary—indeed, unilateral actions will be easier to justify if they are seen as exceptions rather than the rule.

There are three immediate policy changes that would help get U.S. economic statecraft back on track. First, the Trump administration should stop its destructive and divisive trade war, especially with U.S. allies. Given its economic strength, the United States may not lose a trade war with Canada or the EU, but it will not win one, either. Regardless of which side suffers more, a sustained trade war will not just damage the U.S. economy by disrupting long-standing patterns of trade and incentivizing companies to avoid doing business in the United States. It will also limit U.S. power and influence.

Second, the United States should restrict its use of secondary sanctions, deploying them only in pursuit of the most important national security objectives and only after trying and failing to persuade other nations to join in multilateral sanctions. Secondary sanctions are a tempting policy tool, since using them is far easier than working through international institutions or diplomacy. But they should be used sparingly and in coordination with partners. If Washington continues to rely on them without developing a broad consensus in favor of its policy goals, efforts on the part of other countries to reduce their dependence on the United States will only accelerate.

Finally, the United States should seek to coordinate internationally when possible. The Trump administration has sung the praises of independent action, which allows Washington to avoid the compromises that come with multilateral approaches. But although getting buy-in can be time consuming and frustrating, the resulting measures are more likely to succeed and persist. Multilateralism also strengthens international institutions, which distribute responsibility and make it less likely that the United States will have to shoulder a disproportionate share of the burden.

At present, it seems unlikely that Trump will arrest the trend toward more aggressive unilateralism in U.S. economic statecraft; indeed, he may accelerate it. If he does, it will fall to Congress to both control its own impulses toward unilateral action and exercise oversight over executive-branch decisions on sanctions and trade policy, ensuring that these are prudent and in keeping with U.S. interests. It is not too late for the United States to mitigate some of the risks it currently faces and to set the stage for a more effective use of economic statecraft in the future. Doing so, however, will require something more than threats and bluster—it will require an honest reckoning on the part of U.S. policymakers with the limits of American power.