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ISSUE BRIEF

How to Increase Pressure if Diplomacy with North Korea Fails

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Economic Sanctions Initiative

Economic sanctions have become a policy tool-of-choice for the US government. Yet sanctions use, and potential pitfalls, are often misunderstood. The Economic Sanctions Initiative seeks to build better understanding of the role sanctions can and cannot play in advancing policy objectives and of the impact of sanctions on the private sector, which bears many of the costs of implementing economic sanctions.

The uncertain results of President Donald Trump's June 12 summit with North Korean dictator Kim Jong Un, and history of unmet expectations from past efforts, brings home the fact that the United States needs to keep developing tools to intensify the "maximum pressure" campaign that helped bring North Korea to the negotiating table. If North Korea proves unwilling to denuclearize and diplomacy breaks down once again, the Trump administration will need game-changing options in its sanctions arsenal, both to demonstrate resolve and, above all, to avoid stumbling into a nuclear-tipped military showdown under the mistaken belief that viable alternatives do not exist. Transformative options using sanctions are available. But pursuing them will require direct action against China, which has long served as North Korea's economic lifeline and, even before the Trump-Kim meeting, appeared to be resuming trade with Pyongyang.[1]

Indeed, a truly "maximum pressure" campaign on North Korea would require the United States to change China's strategic calculus. Since

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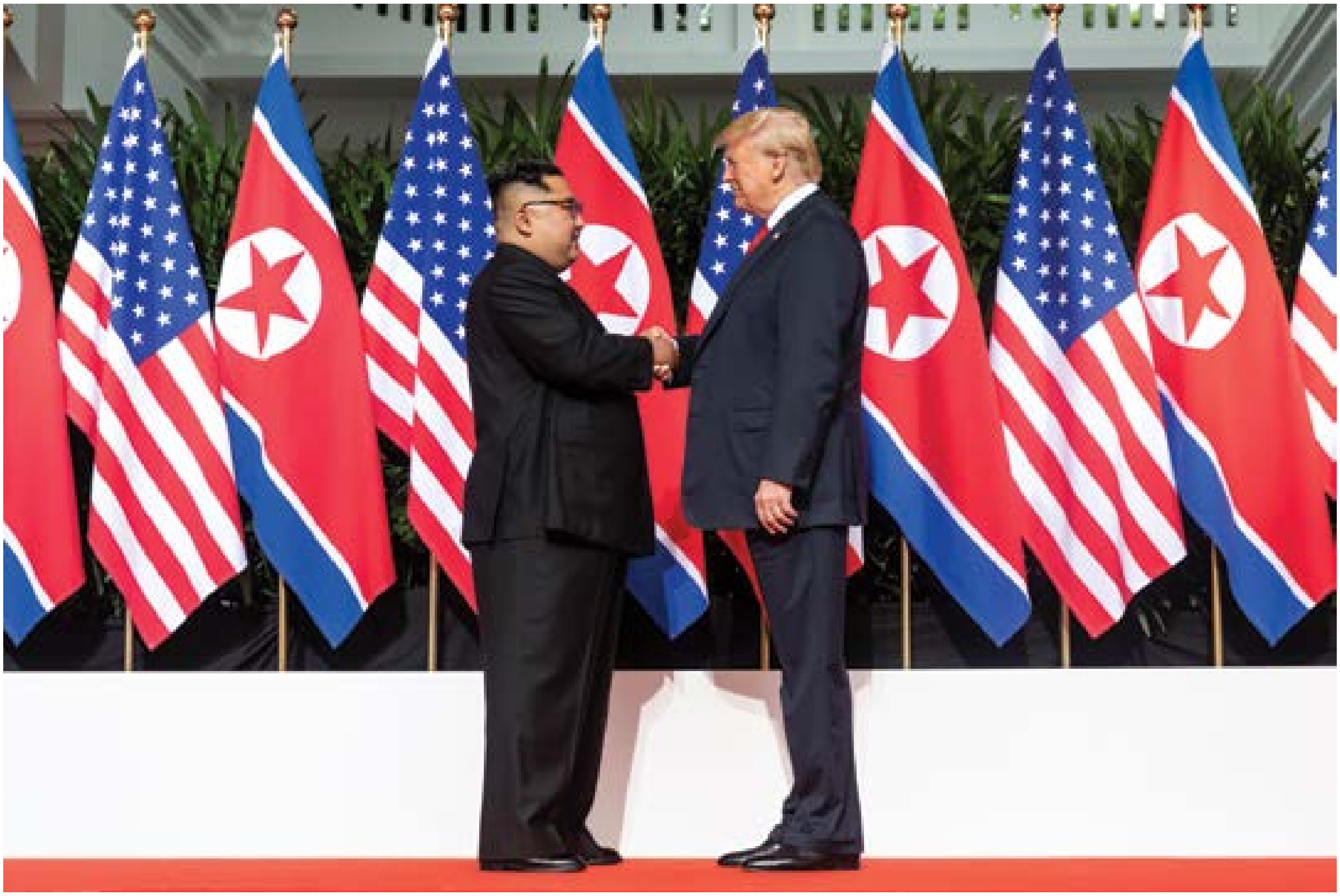
1 See, e.g., Josh Chin, "The Skies Just Got Friendlier Over North Korea and China," Wall Street Journal, June 5, 2018, https://www.wsj.com/articles/the-skies-just-got-friendlier-over-north-korea-and-china-1528199528.



From left to right, North Korean Chairman Kim Jong Un and US President Donald Trump shake hands as they meet for the first time at the long-awaited summit in Singapore on June 12, 2018. Photo Credit: White House (https://www.whitehouse.gov/1600daily/ <https://www.whitehouse.gov/1600daily/>).

early 2017, President Trump and US Ambassador to the United Nations (UN) Nikki Haley have skillfully convinced China to support multiple rounds of UN Security Council sanctions on Pyongyang. Trump has also shown a willingness to impose US sanctions on Chinese companies that engage in commerce with North Korea despite the UN measures, including imposing US sanctions on a mid-size Chinese bank and sanctioning Chinese companies that purchased North Korean commodity exports and sold goods to North Korea. These actions have convinced China to ramp up border inspections and to significantly reduce trade and financial ties with Pyongyang. But none of the sanctions actions last year motivated Chinese President Xi Jinping to fully cutoff North Korea's crude oil supply or block North Korea's remaining exports, as China aims to balance its interest in complying with sanctions against its interest in maintaining long-standing ties to North Korea.[2] The danger exists, moreover, that premature confidence on the part of the US administration about Kim's intentions to denuclearize could weaken even the existing sanctions, by suggesting a US eagerness to lower sanctions as a reward and reluctance to "spoil the atmosphere" by enforcing them. At a minimum, the United States should make clear that it will maintain the current sanctions.

Moreover, should North Korea again demonstrate bad faith and this latest effort collapse, effective new pressure will be needed, and this time will require the credible threat of targeted sanctions against China itself. For the most part, the Trump administration has refrained from directly threatening sanctions against the largest Chinese banks, even though current US

2 See, e.g., Zeeshan Aleem, "It sure looks like China is secretly selling oil to North Korea," Vox, December 28, 2017, https://www.vox.com/world/2017/12/28/16825434/trump-north-korea-oil-china.

sanctions regulations provide the legal authority to take such action.[3] This reflects an intelligent, pragmatic assessment that China's economy, the second largest in the world, projects systemic influence on both the US and the global economy. Without careful design and skillful diplomacy, broad-based sanctions on China would produce unacceptably high collateral damage to US businesses and households. The Trump administration's wariness of macroeconomic sanctions on China also undoubtedly reflects the US economic agenda with Beijing—imposing serious costs on China because of North Korea could complicate US efforts to win concessions on trade and investment policy.

None of this means the United States has no room for maneuver. By drawing on recent innovations in the deployment of sanctions, especially those used against Russia and, more recently, Venezuela, the United States can craft highly precise sanctions authorities against some of China's largest banks' and corporations' activities that could, if used, impose significant costs on China while limiting collateral damage. In the best case, the potency of these measures—and the perception that the United States is willing to use them—would motivate President Xi to align efforts on North Korea with the United States, and the sanctions would never need to be implemented. But even if the sanctions are ultimately executed, they can be calibrated to ratchet up pressure gradually, allowing for a staged implementation and the option to de-escalate based upon China's response.

This issue brief from the Center for a New American Security (CNAS) and the Atlantic Council identifies opportunities to increase pressure on China to curtail its economic support for North Korea by proceeding in three parts. First, it assesses China's financial vulnerabilities. Second, it reviews key US sources of leverage. And third, it provides specific recommendations on potential sanctions if the current diplomatic opening with North Korea fails to resolve the crisis.

China's Financial Vulnerabilities

China's economic strategy has sustained gross domestic product (GDP) growth rates well above those of any other large country, but not without creating mounting vulnerabilities. To meet its self-imposed growth targets in the wake of the 2008 financial crisis, Beijing embarked on an unprecedented economic stimulus program, fueled by expanding credit to Chinese firms through its state-owned banking sector. This led to an investment boom in China, a desperately needed boost to global growth when it was collapsing elsewhere.[4] Since then, instead of consolidating finances, China has continued to binge on credit—albeit with some moderation lately—to satisfy arbitrarily high growth targets.[5] In recent years, it became clear that much of this credit was pumped into unproductive activity, as more than three times as much credit was required to produce the same increment of growth as before the crisis.[6]

The legacy of the post-crisis investment boom created two related vulnerabilities: a highly leveraged economy and growing appetite for foreign capital. Regarding China's debt buildup, total liabilities held by the government, households, and nonfinancial companies surpassed 250 percent of GDP in 2017, exceeding that of the United States.[7] Compared to a decade ago, when China's debt ratio was about 150 percent, the rate of debt accumulation in China is faster than that which occurred in the United States even in the years leading to the 2008 financial crisis. The Chinese banking sector fueled the surge of credit and now ranks as the largest in the world, with assets almost three times the size of China's economy and still growing by double digits each year. By comparison, US banking sector assets are about equal to the size of US GDP, with a much

3 Christian Berthelsen, "U.S. Considered Blacklisting Two Chinese Banks Over North Korea Ties," Bloomberg, April 13, 2018, https://www.bloomberg.com/news/articles/2018-04-13/china-banks-aiding-north-korea-are-said-too-big-to-punish.

4 Enda Curran, "China's Debt Battle Has Global Growth at Stake," Bloomberg, October 29, 2017, https://www.bloomberg.com/news/articles/2017-10-29/global-economy-s-health-at-stake-as-china-tries-to-hold-a-sneeze.

5 International Monetary Fund, "China: Selected Issues, Credit Booms – Is China Different," August 2017, https://www.imf.org/en/Publications/CR/Issues/2017/08/15/People-s-Republic-of-China-Selected-Issues-45171.

6 Chuin-Wei Yap, "China's Zombie Companies Stay Alive Despite Defaults," Wall Street Journal, July 2, 2016, https://www.wsj.com/articles/chinas-zombie-companies-stay-alive-despite-defaults-1468303515; International Monetary Fund, "China: Selected Issues, Credit Booms – Is China Different," August 2017, https://www.imf.org/en/Publications/CR/Issues/2017/08/15/People-s-Republic-of-China-Selected-Issues-45171.

7 Bank of International Settlements, "Statistics on Total Credit to the Non-Financial Sector," Bank of International Settlements Statistical Bulletin, March 2018, https://www.bis.org/statistics/totcredit.htm.

flatter growth trend.[8] The four largest banks in China are the largest four banks in the world with combined assets over $13 trillion.[9]

Despite its rapid buildup of debt, China has avoided crisis—defying the predictions of many outside observers—for three main reasons. First, China benefits from a massive pool of domestic savings that is largely trapped onshore by capital controls and orchestrated by the state-owned banking sector. Second, the vast majority of China's liabilities are denominated in renminbi. Third, the authorities can deploy a mountain of foreign reserves and abundant fiscal resources to backstop the financial system during episodes of stress.

These buffers proved necessary during the turbulence of 2015–2016 when a poorly communicated shift in currency policy triggered a wave of capital outflows and depreciation pressure on the renminbi. China spent nearly $1 trillion of its foreign reserves (about 25 percent of the total) to defend its currency; eventually, tighter enforcement of capital controls and the good fortune of a weaker dollar (which pushed the renminbi stronger) broke the negative feedback loop with capital outflows.[10] But the lesson was clear—even with its considerable defenses—China's internal imbalances leave it vulnerable to a policy shock.

China's top authorities recognize the dangers of the legacy debt buildup. Outgoing central bank Governor Zhou Xiaochuan warned last October of a debt-induced "Minsky Moment": the point at which a speculative bubble bursts and triggers financial distress. President Xi has also prioritized financial stability, announcing last year that deleveraging had become a national security imperative. To their credit, Chinese policy makers have recently managed to slow the pace of debt accumulation—but outright deleveraging has yet to begin.[11]

The second vulnerability, which is directly related to China's swelling debt burden, is that China needs to make a serious push to attract foreign capital. This is perhaps better described as an opportunity cost than a vulnerability *per se*, but one that is still quite relevant in gauging the potency of sanctions. Right now, only about 2 percent of China's $12 trillion domestic bond market is held by foreigners, and about 95 percent of China's liabilities are denominated in renminbi.[12] Out of self-interest, Chinese policy makers are seeking to lure substantial inflows from overseas in the coming years, for several reasons. First, higher foreign investment could help to offset the pent-up domestic pressure to move savings overseas. Second, deeper capital markets in China would relieve the burden on domestic banks to direct credit flows and facilitate their deleveraging process. Third, liquid and diversified capital markets are a prerequisite to establishing the renminbi as a bona fide reserve currency, a major thrust of President Xi's global ambition. Finally, with a narrower current account surplus—down from a peak of 10 percent in 2007 to just over 1 percent last year—China relies more on balanced capital flows to maintain stability in its currency.

For these aspirations to fully materialize, China will need US and other Western financial institutions to include China's bonds on leading benchmark bond indices. Bloomberg/Barclays announced earlier this year plans to include Chinese bonds on their flagship index, and speculation is running high that J.P. Morgan and Citigroup may soon follow. Private analysts estimate that roughly $6 trillion of bonds are passively tracked against these leading benchmarks, and several multiples of this amount are actively managed by private and official sector bond investors that tend to allocate their funds in a similar manner—albeit with discretion on timing and magnitude. Importantly, the vast majority of these investors—excluding those from the official sector—are based in the United States and Europe, well within the reach of US sanctions.

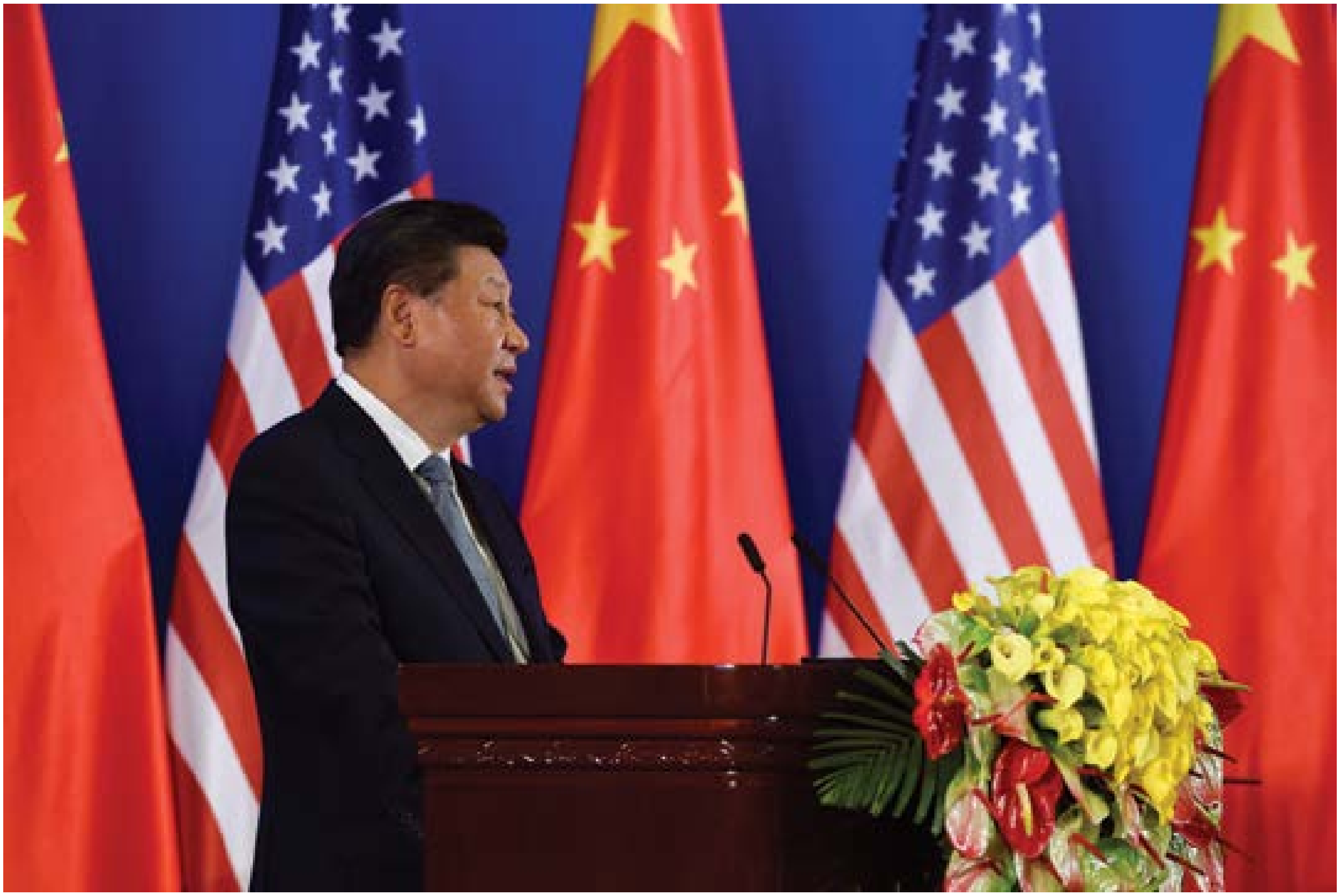
8 International Monetary Fund, "People's Republic of China: Financial System Stability Assessment," December 2017, Country Report No 17/358.

9 "The World's Largest 100 Banks," S&P Global Market Intelligence, May 2018, https://www.spglobal.com/marketintelligence/en/news-insights/research/the-world-s-100-largest-banks

10 Keith Bradsher, "China Moves to Stabilize Currency, Despite Promise to Loosen Control," New York Times, May 26, 2017, https://www.nytimes.com/2017/05/26/business/dealbook/china-currency.html.

11 Reuters Staff, "China says growth of key debt ratio clearly slowing, stabilizing," Reuters, September 2017, https://www.reuters.com/article/us-china-economy-debt/china-says-growth-of-key-debt-ratio-clearly-slowing-stabilizing-idUSKCN1C00NZ.

12 "Global Funds Are Now the Dominant Force in China's Debt Market," Bloomberg, May 15 2018, https://www.bloomberg.com/news/articles/2018-05-15/global-funds-are-now-the-dominant-force-in-china-s-debt-market.



Chinese President Xi Jinping addresses US and Chinese officials at the opening session of the US-China Strategic Dialogue on June 5, 2016 in Beijing, China. Photo Credit: US Department of State (https://www.flickr.com/photos/statephotos/27544686235).

Enduring US Leverage

Indeed, the United States continues to enjoy both tremendous leverage as the central player in the global financial system and the ability to deliver a targeted shock. Despite speculation of its demise, the dollar remains the dominant global currency on any relevant metric: as a means to facilitate international payments (40 percent of total), as a reliable store of value (63 percent of global foreign exchange reserves), and the preferred source of financing (62 percent of international bond holdings). The dollar's standing on these measures has been largely stable or growing in recent years; by comparison, the renminbi's share is 1.6, 1.2, and 0.2 percent, respectively.[13]

The dollar's ongoing primacy is mostly seen as a reflection of US institutional strengths that have proved durable across political cycles. Deep and liquid financial markets, an open system for trade and capital, transparent regulations, and a predictable legal framework are among the distinguishing features. It is also the product of network effects, which have made the dollar-based global financial system more valuable with greater participation. Efficiencies, reach, and stability have grown in proportion to the system's size. Finally, the dollar's endurance at the top also reflects the absence of a legitimate rival—existential challenges in Europe, stagnation in Japan, and uneven reforms in China have all contributed to its status by default.

None of this is to imply that the status quo should be taken for granted. Over the medium term, the dollar's primacy will depend to a large extent on perception—specifically, the hard-earned reputation that US policy makers can be relied upon as responsible stewards of the global financial system. Should this faith erode, the

13 European Central Bank, "The International Role of the Euro," July 2018, https://www.ecb.europa.eu/pub/ire/html/ecb.ire201806.en.html.

incentives for allies and adversaries to hedge their bets on parallel or rival financial architectures may reach a tipping point. While history suggests that the threshold for these shifts are high (e.g., the dollar's displacement of the British pound), the costs of switching to a new currency regime might now be lower with advances in technology and the rise of other economies. For the immediate future, however—and notwithstanding the serious risks involved—the US financial system remains a potent source of leverage in aligning interests with China.

Intelligently Targeting China's Financial Vulnerabilities

There are at least two ways that the United States could target the Chinese economy without major adverse consequences: (a) impose restrictions on Chinese companies' access to new debt and equity financing from the United States, and (b) introduce a tailored measure that would require US banks to subject certain transactions by China's largest banks to heightened scrutiny. Both options are described in further detail here.

Debt and equity restrictions on large Chinese companies: First, the Trump administration could draw a page from sanctions the United States imposed on large Russian banks and energy companies in 2014, and more recently imposed on Venezuela and its state oil company, PDVSA. In 2014, the United States prohibited Russia's largest banks and energy companies from borrowing new money from US investors and institutions and also prohibited US investors from making equity investments in large Russian energy companies. The Trump administration could impose similar measures to prohibit purchases of new equity or debt sales from several of China's state-owned banks and corporations.

These steps would have three primary impacts on the Chinese economy.

First, by removing the supply of financing, the corporations targeted by the sanctions would face higher borrowing costs, including in currencies other than the US dollar. This effect, for example, was felt by Russia's largest banks after US sanctions in 2014, which caused a deterioration in the companies' credit quality, requiring Russian authorities to backstop the sector and to allow regulatory forbearance for the sector to remain solvent. Chinese companies could face similar channels of impact with these sanctions, albeit in much smaller magnitude than in Russia given Chinese corporations' limited reliance on external financing.

Second, it would represent a substantial opportunity cost for China. Foreign inflows into China's domestic bond markets grew over 40 percent last year and are expected to double the 2017 pace this year.[14] As described earlier, Bloomberg has already announced its plan to include China on its global bond index in 2019, and expectations are high for J.P. Morgan and Citigroup to follow suit. Inclusion on these indices could add close to $300 billion of inflows from foreign investors that track these benchmarks, according to private estimates, plus another $150–175 billion from investors that anticipate these flows or make discretionary purchases of Chinese bonds.[15] Separately, the International Monetary Fund's (IMF's) addition of the renminbi to its list of reserve currencies in 2016 will likely induce another $500 billion of inflows from central banks and sovereign wealth funds that allocate their holdings in rough proportion to the IMF Special Drawing Rights (SDR) weightings.[16] Taken together, this amounts to almost $1 trillion of potential foreign inflows to China in the next three to five years that could be jeopardized by US sanctions on purchases of new debt, particularly since these measures would likely impair the liquidity of trading conditions in these securities—a key criteria for index inclusion.[17]

Third, the negative psychological shock would impose a broader chilling effect and likely induce capital outflows from China as a whole. In response, the Chinese

14 Emma Dai, "China's $11 Trillion Bond Market Is Luring Foreign Investors," Bloomberg, January 31, 2018, https://www.bloomberg.com/news/articles/2018-01-31/china-s-11-trillion-bond-market-is-winning-foreign-investors.

15 Reuters Staff, "China bonds to join Bloomberg Barclays Global Aggregate Index," March 23, 2018, https://www.reuters.com/article/china-bonds-index/china-bonds-to-join-bloomberg-barclays-global-aggregate-index-idUSL3N1R54JW.

16 Jamie McGeever, "China's SDR inclusion may lead to $500 bln reserve demand for yuan," Reuters, https://www.reuters.com/article/global-reserves-china-idUSL8N12Q2PK20151026.

17 Emily Glazer, "U.S. Sanctions Could Prompt J.P. Morgan to Push Venezuela From Bond Index," Wall Street Journal, August 24 2017, https://www.wsj.com/articles/u-s-sanctions-could-require-j-p-morgan-to-push-venezuela-from-bond-index-1503614245.

authorities would either need to sell reserves to safeguard the currency or allow the renminbi to depreciate. Neither of these options would be attractive for Chinese authorities: allowing the renminbi to depreciate would risk triggering more outflows in a negative feedback loop, while selling reserves would reduce a public balance sheet that, though still extremely large at about $3 trillion, was already reduced by China's $1 trillion defense of the renminbi in 2015 and 2016.

Importantly, none of these effects would amount to a crippling economic blow. China has an abundance of domestic deposits in its banking system, an abundance of foreign reserves, and plenty of fiscal capacity to buffer the economic impacts. Instead, the measures would accomplish the US goals of demonstrating resolve and increasing diplomatic leverage to align foreign policy objectives with China on North Korea.

A limited "Section 311" action against a large Chinese bank: The second option that the Trump administration should consider is to impose a "Section 311" action against one or more large Chinese banks. Under Section 311 of the USA Patriot Act, the secretary of the treasury is authorized to declare a financial institution or a country a "jurisdiction of primary money laundering concern" and to require US banks to take one or more specified "countermeasures" to reduce their exposure to or increase their scrutiny of the targeted financial institution. In just the last year the Trump administration has imposed Section 311 actions against two banks for North Korea–related transactions: in June 2017, the Treasury announced a Section 311 action against Bank of Dandong, a regional bank in Dandong, China, that was facilitating North Korean financial transactions, and in February 2018, the Treasury announced a Section 311 action against Latvia's ABLV Bank for a variety of illicit financial practices including facilitating North Korean transactions.

Whereas the Trump administration could impose the debt and equity sanctions described above on a Chinese bank even without compelling evidence that the bank itself facilitated North Korean financial transactions, in order to impose a Section 311 action, the Treasury Department must show that the targeted bank has, in fact, engaged in illicit money laundering activities. As a consequence, a Section 311 action would only be appropriate for a Chinese bank to the extent that the specific bank has engaged in illicit transactions with North Korea or other illicit transactions, and China's largest banks have likely at least partially reduced their exposure to North Korea during the increase in US and UN sanctions on North Korea in recent years. However, to the extent that the Trump administration can show that a large Chinese financial institution continues to facilitate North Korean transactions, a Section 311 action would offer a powerful tool to increase pressure on China over China's support for Pyongyang.

Section 311 actions can have serious adverse consequences for targeted financial institutions, particularly when the Treasury Department imposes the most stringent countermeasures and the financial institutions have significant exposure to the United States. For example, the Trump administration imposed the most stringent countermeasures, a prohibition on US correspondent banking accounts, on Latvia's ABLV Bank. In the days following the Treasury Department's announcement, the European Central Bank announced prohibitions on new deposits and withdrawals from ABLV in order to reduce the risks of a "run" on the bank and potential follow-on financial consequences and shortly thereafter announced plans to close the bank in an orderly fashion.

Due to these potentially severe consequences, the Trump administration should approach possible Section 311 actions on significant Chinese financial institutions with great care. If Section 311 actions are not managed carefully, they could incur both near-term consequences such as runs on financial markets as well as long-term consequences like accelerating a trend away from the dollar as the global trading currency.

Fortunately, Section 311 authority provides the Treasury Department with significant flexibility and optionality in implementation. For example, the Treasury Department typically uses Section 311 actions to effectively cut off a foreign bank from the United States. This, for example, is the approach that the Treasury has taken with recent Section 311 actions on China's Bank of Dandong and on ABLV. Legally, however, a Section 311 action gives the Treasury Department significant flexibility to impose more targeted punishments that would increase pressure without fundamentally isolating it from the United States and the international financial system. For example, the Trump administration could use Section 311 to require US banks to obtain detailed information about the nature of transactions that a targeted Chinese bank is processing through the United States and about any of the Chinese banks' customers whose transactions pass through the United States in order to pressure the Chinese bank to eliminate its own exposure to North Korea. While this would dramatically increase the bank's compliance costs and send a signal of risk to China, it would not immediately eliminate the Chinese bank's access to the US financial system. Combined with an appropriate "wind up" period following announcement of a Section 311 action but before the action actually came into force and aggressive outreach by the Treasury Department to explain the action, the Treasury Department can substantially reduce potential unintended, adverse consequences.

Mitigating Risks

Should the Trump administration take either of these serious actions, it should take several steps to mitigate potential adverse fallout.

First, the Trump administration should begin publicly discussing the possibility of sanctions against large Chinese corporates well before imposing them. Floating a credible threat of sanctions would both begin to prepare businesses and markets for the potential sanctions and would also signal the measures to Beijing—potentially encouraging China to take more aggressive steps against North Korea before the United States actually imposed the sanctions.

Second, when taking either of these actions, the United States should publicly express its intent to refrain from crossing certain boundaries. This should include a commitment to apply the sanctions to only a small number of state-owned companies, steering clear of China's private sector. Similarly, the United States should not directly target China's sovereign debt or central bank. Money markets and derivative instruments, which tend to be the "dry tinder" of financial crisis, should be allowed to operate as normal. Treasury should also generally rule out asset freezes against large, systemically important Chinese financial institutions. The United States should keep any Section 311 measures narrowly tailored to continue allowing clearing relationships and the "plumbing" of China's financial system to function in an orderly manner.

Third, if the Trump administration decides to implement the measures, the Treasury Department should engage in extensive outreach to the US, European, and Asian financial sector to explain the measures before they come into effect. While the Treasury Department generally avoids giving advance notice of sanctions actions for fear of encouraging evasion or asset flight, given the delicacy of the measures proposed and the potential for adverse impacts if the measures are not implemented appropriately, the Treasury Department should provide thirty or sixty days' notice before the measures come into effect and use that time to explain the measures to the private sector.

Concluding Thoughts

The measures described in this brief do not represent a complete sanctions strategy if the current diplomatic opening with North Korea fails, and a sanctions strategy against China can never be the entirety of a US pressure campaign to advance its security aims on the Korean peninsula.

Regardless of how tough they are, sanctions need to be embedded in a unified and coherent strategy, articulated from the top. And to be clear—pressuring China into alignment with US North Korea strategy could backfire, triggering an uncontrolled escalation. But set against the alternatives of war, with hundreds of thousands of civilians in the crosshairs, or the acceptance of a nuclear-armed dictator, greatly intensified sanctions are a risk worth taking.

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