

**Senate Banking Committee**

Subcommittee on National Security and International Trade and Finance

Hearing titled: "Secondary Sanctions against Chinese Institutions:

Assessing their Utility for Constraining North Korea"

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Chairman Sasse, Ranking member Donnelly, and members of this subcommittee. In my years at Treasury, I testified before members of this Committee more than any other, and I am honored to present my first testimony as a private citizen before you today. Thank you for convening this hearing on such an important and timely topic and for inviting me to testify today. More broadly, thank you for your longstanding bi-partisan support to my former office, Treasury's Office of Terrorism and Financial Intelligence (TFI). On that note, I would respectfully urge that you move deliberately but quickly to confirm Sigal Mandelker, who has been nominated to serve as under secretary overseeing this office, including Treasury's intelligence, sanctions, and money laundering authorities. It is critical that TFI have a confirmed under secretary in place, and I know Sigal to be an exceptionally intelligent, experienced, and strong leader.

I am often asked whether – as with Iran – the international community could generate enough sanctions pressure to force the North Korean government to the table to negotiate a peaceful and verifiable end to its nuclear weapons program. It is of course an intensely difficult question, as it requires assessments of notoriously opaque issues, such as the internal thinking of North Korea's leadership, its internal power dynamics, and possible succession scenarios. That said, I believe the answer is a qualified "yes." Whether new secondary sanctions legislation is needed or advisable at this stage is a related but separate question that I will take up in turn.

My topline assessments are as follows:

1. North Korea is not self-reliant or "sanctions proof." Its leadership depends upon access to foreign goods and international banking services, the denial of which would quickly build substantial pressure on its leadership.

2. Unlike in Iran's case, which enjoyed diverse access to the international marketplace, sanctions leverage over North Korea is concentrated in one country – China. If China is prepared to take a qualitatively tougher stance on sanctions against North Korea, sanctions have a real chance to succeed. If not, they have none.
3. Despite years of high-level international attempts, China has resisted more than incremental enhancements to its sanctions posture. China is risk averse when it comes to North Korea, and for understandable reasons.
4. U.S. sanctions alone will not force China to adopt a qualitatively tougher approach, no matter how draconian and costly those sanctions become. China is exponentially more concerned about the fate of North Korea than it is about Iran, and China will not be strong-armed into a course of action that it believes imperils its national security.
5. Serious and high-level engagement will therefore be needed to assure China that (1) this issue is paramount for the United States, above other commercial and geopolitical priorities; (2) the proposed sanctions campaign against North Korea is aimed at enabling nuclear diplomacy not regime collapse; (3) our interests in this diplomatic effort overlap with and are reconcilable with China's national security interests, including maintaining stability on the Korean peninsula.
6. As part of a stepped up sanctions effort around targeting North Korea's activities around the world, the U.S. will almost certainly need to sanction complicit Chinese entities, both to combat sanctions abuse and to demonstrate our seriousness of purpose. The Administration has ample authorities to do so already. If new legislative authorities become necessary down the road, it is important to introduce them only once the strategic and diplomatic groundwork has been laid.

To begin, all experts agree that the threshold of pressure that will be needed to even bring North Korea to the negotiating table is extraordinarily high. Kim Jong Un doesn't just see his nuclear weapons program as one pillar of his country's national security. He sees it as the primary guarantor of his regime and his personal survival. The only conceivable scenario in which Kim Jong Un would consider negotiating over his nuclear weapons program is if he believes that – unless he does so – he is at risk of a near-term loss of power. This means that the required threshold of sanctions pressure will be high and cannot be expressed as an incremental add-on to the status quo. I will return below to what the requisite level of pressure would look like in practice.

Some experts believe, however, that even if the sanctions pressure reaches the point where Kim Jong Un fears for his hold on power, he would persevere and risk being deposed rather than give up his nuclear weapons and, in his mind, guarantee his demise. That assessment may well be correct. If so, the global community needs to see a different leader in Pyongyang, one who is willing to address the security concerns of the international community. Either way, it will be necessary to build international pressure to the point where it threatens leadership change.

Because I am unable to predict Kim Jong Un's internal calculus, I framed my central question not around his personal decision-making, but rather whether international pressure could force a North Korean government to the table to negotiate a verifiable end to its nuclear weapons program. Faced with suffocating international pressure, I do believe that a North Korean leader would be willing to negotiate the disposition of the country's nuclear weapons in exchange for survival and some form of diplomatic and economic re-integration.

It is vital to remember here, as elsewhere, that toughened sanctions in and of themselves are not a strategy. Massive diplomatic investment and multilateral engagement will be needed to marshal a successful effort, and it will require enlisting likeminded and resistant countries. Having participated in a comparable campaign with respect to Iran, I would urge the Administration and Congress to staff leadership positions at the Treasury and State Departments quickly. And I believe that it would be counterproductive in the extreme to deplete our foreign service corps at a time when we need them so urgently – both on this issue and the whole range of national security and foreign policy threats we face.

What would a sufficiently tough sanctions program look like and how would it be obtained? The good news here is that – contrary to some observers – North Korea is not somehow “sanctions proof.” It is highly isolated but it is not self-reliant. In fact, in many ways, its isolation renders it more vulnerable to sanctions pressure than Iran was in the mid-2000s when we commenced our pressure campaign.

North Korea's anemic economy requires imports of petroleum, coking coal, and textiles. Its antiquated industrial and communications sectors require significant imports of machinery, equipment, and expertise. On top of the general economic needs of the country, Kim Jong Un depends upon a system of patronage to purchase the loyalty of senior political and military officials, for which he needs to import foreign luxury goods such as cars, technology, and high-end consumables. In the aggregate, these imports and purchases are estimated at approximately \$5 billion a year. None of them can be bought

using North Korean currency; no exporter outside of North Korea will accept payment in North Korean won. All of this means that the leadership of North Korea must (a) continuously generate new foreign currency earnings through the sales of minerals, weapons, counterfeit goods, etc.; (b) receive payment for those exports in foreign bank accounts via the international banking system; and (c) pay for and arrange for the delivery of needed imports.

A North Korean leader depends on all three of these elements, both to stave off a broader economic collapse and to maintain the loyalty of his inner circle. The first two elements are the most exposed to sanction pressure. I assess, then, that a stepped up sanctions campaign would need to target North Korea's foreign currency earnings – for example by dramatically reducing North Korea's sales of coal and other minerals – and would need to disrupt North Korea's access to the foreign bank accounts it currently enjoys.

Multiple U.N. Security Council resolutions, binding on all U.N. member states, have already targeted North Korean exports, imports, as well as its financial activity and now prohibit the purchase of North Korean coal and minerals and the maintenance of correspondent accounts for North Korean entities.

In terms of implementation, the key question is and has always been China. To bring the pressure up to the threshold required, we must find a way to enlist the cooperation of the Chinese government and the compliance of Chinese private actors. This is not a hopeless task. China is not comfortable with either Kim Jong Un or with North Korea's burgeoning nuclear and ballistic missile capabilities. Indeed, the North Korean leader has at times gone out of his way to provoke China's leaders, snubbing Chinese diplomats, timing provocative missile launches to the Chinese New Year celebration, and murdering senior North Korean officials who had good relations with China. China would also strongly prefer that North Korea not have a nuclear weapons program, both because of the instability it engenders in the region and because it has justified a robust U.S. military presence just off China's shores, including the recent deployment of the THAAD anti-missile system in South Korea. I believe that China would breathe a huge sigh of relief if it could successfully resolve the world's concerns over North Korea's nuclear weapons program.

We have seen China act on those concerns, including in the realm of sanctions. China has not just acquiesced in the last two U.N. Security Council resolutions targeting North Korea, it has co-sponsored them with the United States. The resolutions have had real teeth, including new mandatory sanctions against North Korea's exports of coal, its import of luxury goods, and its ability to bank. And China has

periodically acted against individual agents and entities in China, when pressed firmly by the United States. This includes Ma Xiaohong and the Dandong Hongxiang Industrial Development Company, an important North Korean facilitation network that was targeted by the U.S. Justice Department, sanctioned by the Treasury Department, and ultimately investigated by Chinese authorities for “serious economic crimes.”

That said, China’s implementation of the U.N. sanctions has been spotty and decidedly incomplete. Time and time again, we have seen China pull back from implementing the toughest measures, whether at the level of broad economic measures or targeting specific sanctions evaders in China.

The problem is that, as much as China may dislike Kim Jong Un and his nuclear program, there is an alternative that is far worse from China’s perspective, which is North Korean regime collapse. Even an erratic Kim Jong Un is preferable to a regime implosion, which could immediately trigger an outpouring of millions of indigent refugees across China’s border, a struggle for control over North Korea’s military and nuclear programs, and the potential prospect of reunification of the Korean peninsula under a South Korean government, bringing a close U.S. military ally to China’s borders.

It is important to recognize, then, that China will not ratchet up the pressure on North Korea to anything close to a leadership-threatening level unless it understands what comes next and views the scenario/s as acceptable. China will not “roll the dice” when it comes to the fate of its impoverished, nuclear-armed neighbor, and concerns over stability will be paramount.

Threatening and/or imposing U.S. secondary sanctions against Chinese targets may change the conduct of individual Chinese entities or banks from afar, then, but it will not bring about the kind of comprehensive and sustained crackdown by Chinese authorities, traders, bankers, and businesspeople that is required to bring North Korea to the table. That type of sanctions pressure will only be obtained when the Chinese government agrees to apply it.

I want to pause here to address two counter-arguments that I hear. First, we forced China to cut its oil imports from Iran using secondary sanctions, so secondary sanctions should work in this context as well. Second, even if the Chinese government doesn’t agree, Chinese businesses and banks will comply with secondary sanctions because, given a choice between doing business with the United States or North Korea, all banks and businesses will choose the United States.

The arguments are flawed for a few reasons. First, the stakes for China were dramatically lower in the Iran case. If the sanctions pressure worked and an international solution to Iran’s nuclear program was

reached, that would be good for China. If the sanctions fell short, China had played a responsible role in the international community. If sanctions over-achieved and provoked instability in Iran, China was not a primary or even secondary stakeholder. Put simply, Iran plays a minimal role in China's geopolitical outlook compared to North Korea.

Second, while it is true that we won grudging Chinese acquiescence to curtail imports of Iranian crude oil, months of painstaking diplomacy were needed and what China did was easier and more limited than what we will need them to do here. China reduced its crude oil imports from Iran by a certain percentage every six months as it lined up alternate sources for its crude oil. And it escrowed Iran's oil earnings for use in bilateral Iran-China trade only – notably, a restriction that hurt Iran but benefited Chinese exporters. We will need far more extensive and proactive cooperation here. Iran was conducting its business with China largely in the ordinary way. Iran's correspondent accounts were easily identifiable and oil tankers cannot be smuggled across a border. North Korea conducts its banking activity and trade more like a criminal organization than a country – through cut-outs and agents, such as front companies posing as ordinary Chinese trading or business enterprises. This means that a large bank in China may be hosting millions of dollars of North Korean financial activity without any direct relationship with a North Korean person and, potentially, without knowing it. The type of rigorous investigative and enforcement effort that will be required to police North Korean covert banking activities and smuggling far outstrips what China did in the Iran context.

Third, secondary sanctions are a blunt and unpredictable instrument and their application carries broad risks for the U.S. and our allies. To focus on the banking arena, as noted above, North Korea generally conducts its financial activities surreptitiously through cut-outs. As such, the Chinese banks involved fall along a spectrum of awareness. In some cases, they may indeed be complicit, and looking to facilitate North Korean activity for a profit. In many cases, they may be hosting North Korean transactions without knowing it, but where we would assess that they could be doing more to detect and prevent this activity. Finally, there are instances where Chinese institutions are practicing all due care and are nevertheless still being abused, as large and careful U.S. and European banks will have criminal proceeds moving through their institutions under the names of agents and front companies. Secondary sanctions are an extremely blunt instrument to respond to such a spectrum of conduct. In practice, their use means that a target is completely severed from the U.S. financial system, a condition that – for an internationally active bank – is generally tantamount to a death sentence. That power and lack of adjustability is both a strength and a limitation.

In this context, we should note the types of entities we are discussing. The four largest banks in China are the four largest banks in the world, each larger than J.P. Morgan Chase by assets. Yes, they are inextricably dependent on access to the U.S. financial system but the dependencies run both ways. They hold several trillion dollars of assets in our markets and at our largest institutions. By comparison, Lehman Brothers before its collapse was only one-seventh as large. The implosion of one of the world's largest financial institutions is not something to be trifled with. It would send shock waves through the international financial system and trigger large and unpredictable fall-out. And none of this is to consider the inevitable response and counter-sanctions from China.

The fourth error made in assessing the viability of secondary sanctions is that, with some targets, they may have little to no impact. A trading firm or coal importer in Dandong province that does tens of millions of dollars of business with North Korea may do no business with the U.S. or Europe. Forcing a choice between doing business with North Korea or the United States may be an easy one for that firm, and not in the direction that we would like.

For all of these reasons – and other longer-term costs and risks that time does not allow me to address here – we need to be exceptionally judicious in our use of secondary sanctions. And creating the authority just to have it available carries risks as well. As a sanctions practitioner, I believe that we do ourselves and our credibility major harm if we unsheathe this powerful weapon without understanding if and how we are prepared to use it. America has had major successes in its use of sanctions in the last decade, but one of the reasons for those successes is that we do not bluff. Were we to depart from this practice, we would see our sanctions credibility undercut, not just in this context, but across a whole range of vital national security and foreign policy portfolios.

A comparison with the use of secondary sanctions vis-à-vis Iran is instructive. In that context, the Bush and Obama administrations had aggressively deployed primary sanctions for years to target those entities colluding with Iran, and brought costly enforcement actions against global banks that were evading our sanctions. The administrations coupled these actions with an extensive outreach campaign, approaching governments, banks, and businesses to ensure that they understood the gravity of Iran's conduct, the primacy of this issue for the United States, and the risks of a lax approach to Iran. In response, the world's first-tier banks exited their Iran business and every relevant jurisdiction began to subject its Iranian trade to careful scrutiny and diligence.

Congress then turned the heat up considerably in 2010, with a series of secondary sanctions bills. The Administration worked with Congress to refine those bills, ensuring that they included aggressive but attainable thresholds and sufficient discretion and waivers to allow the Administration to use them effectively across a range of countries and circumstances. And the Administration was staffed and ready to immediately deploy senior officials to every corner of the world upon passage. The result was the most effective sanctions campaign the world had ever seen, as Congress's secondary sanctions dramatically amplified the work that the Administration had underway. Second- and third-tier banks that had picked up the Iran business as it was shed by their larger competitors suddenly exited. Iran's crude oil exports dropped by 40%. And Iran's leadership saw only one way out – through negotiations over its nuclear program. The outcome is remembered clearly, but we also need to remember the preparation and work that allowed it to succeed. That groundwork has not yet been laid in the case of North Korea.

My conclusion then, is that we cannot unilaterally sanction China into imposing the type of sanctions pressure necessary to change North Korea's course. We will need to win China's cooperation. This will require serious diplomacy, and both carrot and stick. As part of that effort, I suspect that we will need to sanction Chinese entities that are knowingly doing business with North Korea, both to show China that we are serious and to combat sanctions evasion. The Administration has the authorities to do that already. But the key to success will be high-level diplomacy to take up and work through China's interests and reconcile them with our own.

There is enough overlap between China's interests vis-à-vis North Korea and our own concerns with North Korea's nuclear program to allow for a mutually acceptable approach. And there are many incentives and irritants in our bilateral relationship with China that could be used to facilitate this diplomacy. But China must know that we have thought through the steps that follow after crippling pressure is applied, and that China's core national security interests will be protected. From China's side, it would be helpful if China identified one or two senior officials who could speak for President Xi on addressing the North Korean nuclear threat, across the range of diplomatic, strategic, and financial facets involved.

Against such a diplomatic backdrop, a range of sanctions approaches could be drawn up. As noted earlier, I see the primary targets as North Korea's access points to the international financial system and its export earnings, primarily from the sale of coal, minerals, and weapons. A campaign plan could be structured and staged in various ways to dramatically increase the pressure against North Korea. If the

international community were to fully cut off North Korea's coal exports alone, it would drop the country's foreign revenue earnings by more than one-third immediately.

The U.S. Administration is already well-armed with sanctions authorities to play a leading role in such a global sanctions effort. The Treasury Department has broad and flexible authorities to sanction businesses, trading firms, and banks anywhere in the world that are facilitating North Korea's activities or providing North Korea's banks with surreptitious access to the global financial system. What the effort will require, though, is senior leadership in the Administration to lead the charge and the resources and bodies to sustain it. Those resources will be needed at State, at Treasury, and in the intelligence community – an effort of this scale and sophistication will necessarily require a full-court, sustained interagency press. As such a campaign progresses, the Administration may need additional authorities from Congress – including potentially secondary sanctions – but such authorities should be deployed to advance a strategy not in advance of one.

Of course, even with a concentrated and strategic effort, we cannot guarantee that a diplomatic effort powered by new sanctions pressure will succeed. But it has a chance to do so. And, faced with this ever-growing threat and absent a better alternative, I believe that it is our duty to put all of our energies into this effort.

Thank you again for inviting me to testify.