

Sectoral Sanctions: The Long Arm of Coercive Diplomacy

In the conflicts with Russia and Iran, Western countries are using sanctions as a core instrument of international politics. It is still unclear whether sanctions against the finance and energy sector contributed to the diplomatic breakthrough with Iran. However, it is hoped that such measures can convince Russia to back down.

By Mark Daniel Jaeger

Sanctions continue to play a prominent role in international politics. They are issued in response to violations of fundamental international norms ranging from humanitarian and international law to the proliferation of weapons of mass destruction. Sanctions are also based on the premise that economic pressure will have a political effect and influence the calculations of political elites.

Since the beginning of this century, targeted sanctions have aimed to minimize the effects on the general population (cf. [CSS Analysis No. 83](#)), unlike in the case of Iraq during the 1990s. However, in two geopolitical conflicts during recent years, sanctions have departed from this established practice of targeted measures and have been applied to entire economic sectors of geopolitical antagonists. Sectoral sanctions against the finance and energy sector, initially tried out against Iran, are now also being applied in the case of Russia. Their overall economic effect is significant. It is unclear, however, whether it was enhanced economic pressure that caused Iran's new willingness to engage in dialog under President Hassan Rohani, and whether such robust sanctions against Russia will achieve anything.

Irrespective of whether this new generation of sectoral sanctions is indeed more effective



The introduction of sectoral sanctions by Western countries had a major impact on the Russian economy. *Maxim Shemetov / Reuters*

politically, the fact is that it creates international legal disputes. The contentious nature of sectoral sanctions is due to the fact that they may also compel any potential market actors from neutral countries, such as Switzerland, to participate in their implementation. “Extraterritorial” US sanctions exploit the dominance of the US market, coercing foreign companies to implement US legislation.

Iran: Successful Sanctions?

It is tempting, in view of the progress achieved in the dialog over Iran's nuclear program after Rohani's election as president of Iran in 2013, to attribute the breakthrough to the sanctions on the country, which were sharply intensified after 2010. At the beginning of April 2015, the talks between Iran and the P5+1 (the permanent members of the UN Security Council

(UNSC) and Germany) brought a basic agreement that is to result in an agreement by the end of June 2015. After years of confrontation, this constitutes a diplomatic breakthrough.

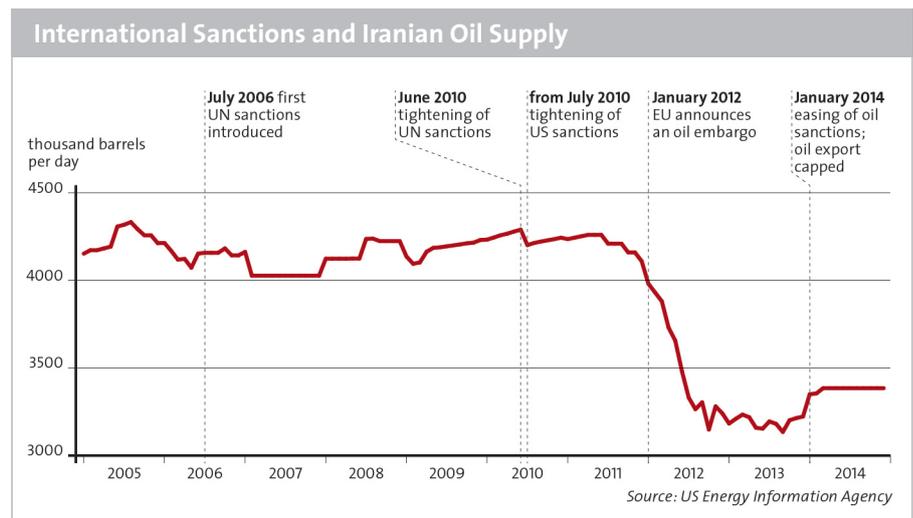
The policy of developing nuclear technology, which was stepped up under the presidency of Mahmoud Ahmadinejad, was assessed by the IAEA as violating Iran's obligations under the Nuclear Non-Proliferation Treaty. As a result, the UN in 2010 enacted a massive expansion of the existing sanctions regime. UNSC Resolution 1929 effectively aimed at excluding the country from the international financial system.

In addition to these sanctions, which are binding upon all UN member states, the US, the EU, and Switzerland imposed additional sanctions beginning in 2010. The US sanctions also emphasized Iran's financial sector. The *Comprehensive Iran Sanctions, Accountability, and Divestment Act* (CISADA) includes penalties for business relations of any type between Iranian banks and US and international financial institutions. To this end, Iranian institutions as well as foreign banks that do business with Iranian partners are barred from maintaining correspondent accounts in the US mar-

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ket. Since such accounts are generally indispensable due to the role of the US dollar in the international financial system, this is an effective means of control. The US already imposed sanctions against the Iranian energy sector in the *Iran Libya Sanctions Act* of 1996, including punishments for foreign companies engaged there economically.

The US were not the only ones to expand the sanctions considerably after 2010. In a coordinated effort, the EU and Switzerland followed suit, tightening their sanctions. The EU also expanded its restrictive measures to include the financial sector as well as the oil and gas sector; initially, severe constraints were imposed on financial deals, and they were subsequently banned altogether. In Switzerland, too, the existing sanctions were stiffened even further. Banks were forbidden from engaging in new business relations with Iranian banks;



insurance and reinsurance companies were banned from dealing with legal entities as well as certain natural persons. For oil-related transactions with Iranian enterprises, a reporting requirement was introduced.

The tougher sanctions caused broad economic fallout, especially from 2012 onwards. The shortage of US dollars set off a massive devaluation of the Iranian currency. The exchange rate with the US dollar, which stood at roughly 9,500 rial in 2010, climbed to over 25,000 by 2013. The inflation rate, already at 20 per cent in 2011, passed the 40 per cent by 2013. Moreover, oil exports to OECD countries were effectively halved between 2012 and 2014, while production fell from 4.3 million barrels a day in 2011 to 3.2 million barrels at the end of 2012. The economy contracted by over five per cent between 2012 and 2013.

There is little doubt that sanctions can have considerable economic effect. One of the lessons of the sanctions regime against Iraq and its disastrous economic effects in the 1990s was the shift towards targeted sanctions against certain legal entities and natural persons who are closely linked to a regime. By setting a narrow focus, the economic effects for the population at large can be minimized.

The changes in the sanctions against Iran are in clear contravention of this trend towards minimally invasive targeted sanctions that has become apparent in international politics since the turn of the

millennium. The sanctions against Iran were long considered to be too lax and lacking broad international support. Their chances of success were regarded with skepticism. A new factor is the use of systematic sectoral sanctions on a broad international front that take into account severe economic effects.

Now, from the summer of 2013 onwards and thus relatively soon after sanctions against Iran were tightened across the board, a new Iranian government signaled a willingness to engage in dialog. Does this vindicate the decision to impose sectoral sanctions? Did Iran buckle under the consistent, comprehensive sanctions imposed in response to its violation of international law? It is far more difficult to establish a causal nexus between this readiness to engage in dialog, which reflects a shift in the political calculations of the Rohani government, and the sanctions regime than to pinpoint the very immediate economic effects. Discontent with the previous government had already been widespread years before the sanctions were tightened, as seen in the 2009 "green movement". In Iran's complex political system, the secular opposition was complemented by antagonists of Ahmadinejad in the conservative camp. Rohani, who is part of this conservative establishment, is pursuing a moderate policy that is more conciliatory domestically than that of his predecessor. Iran's revolutionary leader Ayatollah Ali Khamenei was hardly interested in further polarization. Accordingly, Iran's political shift may be attributed to other, more important factors. Sanctions may then have assisted this process without necessarily having brought it about.

Russia: Weighed Down By Sanctions?

The sanctions imposed by the US and the EU in the course of the Ukraine crisis from March 2014 onwards are justified by Russia's violation of international law. In addition to the illegal annexation of Crimea, Russia's targeted destabilization of a neighboring country is cited as the main justification for the sanctions.

Unlike the sanctions against Iran, the ones imposed on Russia were not legitimized by a UNSC decision, as Russia has the power of veto in that body. Otherwise, however, there are some remarkable similarities between the sanctions policy vis-à-vis Russia and the Iranian sanctions regime. At the end of July 2014, the sanctions were expanded in two ways: The EU and the US not only banned sales of arms and dual-use goods, but also specifically targeted exports of technologies required in the high-powered market for energy exports, where Western-made high-tech equipment is difficult to replace. Additionally, access to the international financial system was severely restricted for Russian banks and corporations. Since July 2014, US financial institutions and individuals domiciled in the US may no longer maintain business relations with a number of major Russian banks and corporations. The EU followed suit by excluding state-owned Russian banks and other Russian businesses from the European capital markets. In addition to these measures, an exclusion of Russia from the SWIFT payment system was considered – a step that had severely curtailed the international payment transfer options of Iranian financial institutions from 2012 onwards.

Switzerland followed the EU's moves quite closely. On the one hand, it did so by taking measures to prevent deals that might circumvent the international sanctions. This decision, in effect since April 2014, applies to certain natural persons and legal entities linked to the Russian government. Furthermore, there is a ban on doing business with entities domiciled in Crimea or Sevastopol that violate Ukrainian law. Conversely, since August 2014, exports of military equipment and of goods that can be used for military purposes or in the oil industry are forbidden or subject to compulsory registration.

As in the case of Iran, the penalties imposed on Russia mark a notable turn away from narrowly focused, targeted measures towards sectoral sanctions. Although Rus-

sia is not subject to as tight a sanctions regime as Iran, the Russian financial sector has come under intense pressure. Since mid-2014, the Russian currency has lost around half of its value vis-à-vis the US dollar. Inflation has lately reached double digits; a high prime rate rests heavily on the economic outlook. These factors put the financial sector, and consequently the entire national economy, in jeopardy.

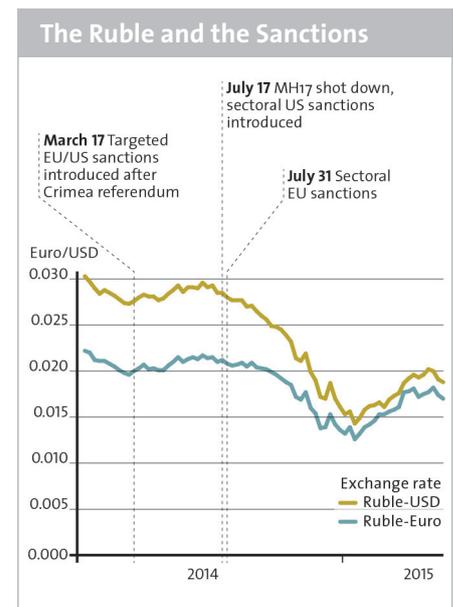
A crucial factor in this constellation is the decline of energy prices, which has caused steep revenue shortfalls for corporations and public coffers. Due to the sanctions, access to international capital is largely blocked. By obstructing the development of urgently needed new sources, the sanctions have also created bleak prospects in the middle term. In its current forecast for Russia, the International Energy Agency (IEA) sets a gloomy tone, anticipating a potential "perfect storm", with the country's oil production being pushed into contraction.

Despite the similar sanctions policies, the cases of Iran and Russia are quite different, however. This is not only true for superficial material aspects, such as military capability and economic interdependencies, both of which are greater in the case of Russia. According to the latest insights of sanctions research, variations in the constellations of conflicts have considerable influence on the effects of sanctions. The perception of a conflict determines the willingness to compromise. If the two parties have fundamentally differing understandings regarding the nature of the conflict, sanctions may be counterproductive. In Iran, we find no conflict perceptions that are diametrically opposed to those of the Ahmadinejad and Rohani governments. However, there is no denying that Rohani is far more optimistic than his predecessor in his assessment of

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options for cooperation with the international community – even though sanctions were tightened even further after his accession to office.

Iran's growing openness towards dialog and Rohani's pragmatism are in stark contrast to the highly polarized perception of the conflict between the West and Russia. Ac-



ording to the Russian narrative, the West is seen as attempting to encircle Russia, while Ukraine's orientation towards Western Europe and the sanctions are symptoms of hegemonial aspirations. Crimea, on the other hand, is seen as Russian territory restored to its historically rightful status by the 2014 referendum. Putin's government enjoys support in the Russian population for its actions in the Ukraine crisis, a view reinforced by the state-controlled media. Therefore, negative economic developments should not necessarily be expected to bring about comprehensive political concessions by Russia. Unlike in Iran during Ahmadinejad's term in office, there currently seems to be no strong, moderate political opposition. Moreover, the potential consequences of a downfall of the Russian government are completely unpredictable.

Sectoral Sanctions and Switzerland

Traditionally, the question of participation in international sanctions has impinged on the principle of neutrality in Swiss foreign politics. Since the end of the Cold War, Switzerland has demonstrated solidarity by applying UN sanctions, regarding them as compatible with the principle of neutrality (cf. *CSS Analysis No. 83*). A flat refusal to participate in the sanctions regime based on neutrality would not be nearly as simple as it sounds. If Switzerland regards the policies of Iran and Russia as violations of international law, Swiss abstinence in sanctioning such violations would be regarded as signaling approval, rather than as a genuinely neutral stance.

But there are also pragmatic foreign-policy considerations that militate in favor of abstinence. With its independent political stance, Switzerland is frequently able to undertake a mediating role on the international stage. This may occasionally serve the purpose of international diplomacy better than categorical implementation of sanctions. The Federal Council must try to achieve a balancing act between several important principles of Swiss foreign policy.

However, the sectoral sanctions against Iran and Russia have a new, volatile quality. The financial sanctions that have been imposed effectively diminish Switzerland's ability to avoid participation even if it should prefer to do so for political reasons. Especially since the attacks in New York and Washington in 2001, the US has significantly boosted its ability to enforce extraterritorial financial sanctions as part of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act. For example, entire states may now be designated a "Jurisdiction of Primary Money Laundering Concern", as in the case of Iran. Financial transactions of any kind with such countries are forbidden.

The enforcing authority in the US is the *Office of Foreign Assets Control* (OFAC). Its long arm also reaches foreign financial institutions that depend on access to the US financial markets, and as participants in that market are subject to US jurisdiction. This is the basis for the application and implementation of extraterritorial sanctions. It also applies to financial corporations based in Switzerland. For them, the compliance pressure is quite intense. Avoiding sanctions, or even violating a duty of care, carries considerable risks and severe penalties. The case against BNP Paribas is a case

in point. In 2014, the bank settled for a payment of a US\$8.9 billion penalty and was banned from making clearing transactions in US dollars in the oil and gas business for one year. Credit Suisse, too, has been affected in the context of Iran and paid a settlement of more than half a billion US dollars in 2009.

Extraterritorial financial sanctions can be robustly enforced. Having proven their worth against Iran, they are also politically popular as an instrument to be wielded against Russia. In this case, Switzerland supports the international sanctions; domestic financial institutions are subject to special legal stipulations under Swiss law.

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In the case of Iran, this was not always the case. For a long time, US extraterritorial sanctions were unilateral measures. Under international law, the notion of third-party liability in a conflict violates the right of neutral countries and their citizens to engage in commercial relations with parties to the conflict. This is not a problem as long as there is agreement between the US and Switzerland over sanctions systems. In the absence of such agreement, extraterritorial financial sanctions constitute violations of sovereignty. The EU has responded by explicitly forbidding its corporate actors from yielding to unilateral extraterritorial sanctions.

Pitfalls of Sanctions Policy

The increasing use of sectoral sanctions marks an about-face from the concept of "targeted" sanctions, which had aimed at narrowly limiting the effects of sanctions on the general public. Sanctions against the finance and energy sectors proved to be ef-

fective instruments with considerable economic impact. At the same time, financial sanctions are a comfortable instrument for those that initiate them: The implementation and enforcement of such restrictions is primarily the responsibility of international financial corporations. However, the absence of any basis in international law may prove to be a boomerang that could be fatal for the future of extraterritorial financial sanctions.

Assessing the political effectiveness of sanctions requires reflection on their aims. In the conflicts with Iran and Russia, the initiators wish to punish violators of international legal norms. Sanctions achieve this aim irrespective of whether or not the countries in question back down in the conflict. In the case of Iran, moreover, sanctions have already achieved a further aim: containment. They have helped to slow down the Iranian nuclear program.

Thus, questions about the future also pertain to sanctions in the specific cases under discussion. Here, a healthy dose of skepticism is advisable. Agreement with Iran in the current negotiations will not automatically bring an end to sanctions. Not all of these are targeted at the nuclear program; some were also imposed in response to human rights violations and political repression. Also, in view of the current majorities in the US Congress, US President Barack Obama cannot expect unreserved support for his foreign policy. A diplomatic breakthrough is a necessary, but not a sufficient condition for the end of sanctions.

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