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The Export of Sanction Policies: Extraterritorial Sanctions and Geopolitical Conflict

KEY MESSAGES

- **The geopolitical rivalry between the US and China may spill over to Europe via extraterritorial sanctions**
- **The US-Iran conflict shows that Europe losing access to the US market has been a powerful threat to limit Europe's trade with Iran**
- **US extraterritorial sanctions, seen as a tool to limit Iran's sponsorship of international terrorism, became more attractive as the US became a energy exporter**
- **Countermeasures against extraterritorial sanctions exist but proved largely ineffective in the past**
- **European countries need to invest in strategic sovereignty to prepare for a possible fallout from the US-China geopolitical conflict**

Russia's invasion of Ukraine has brought sanctions to the forefront of the political agenda. The broad coalition of countries arrayed against Russia is surprising, given that French President Macron considered NATO brain-dead not long ago and international coordination of economic policies experienced setbacks because of the UK's Brexit decision and former President Trump's unilateral policy agenda of "America First."

Beneath the broad-based alliance against Russia are cracks, however, that speak to countries' partly diverging interests. An example is the EU's oil embargo regime against Russia, which allows for reduced Russian oil exports to some EU countries because of their difficulty of finding energy substitutes quickly. Diverging interests are also reflected in the number of abstention votes in the UN General Assembly condemning Russia's invasion.

The heterogeneity of interests is neither surprising nor per se bad. In this article, however, I argue that the rising geopolitical rivalry between the United States and China may allow little room in the future for diverging policies among Western allies. In fact, US policymakers may demand that European allies take a hard stand against China, be it in technology or economic exchange. While Europe's strategy vis-à-vis China appears to be one of de-risking, decoupling appears to be on the horizon for both the US and China.

The instrument for extending the own (sanction) policy to other countries abroad is extraterritorial sanctions, also called secondary sanctions, which forces allies who do not follow the same sanction policies on their own to move in lockstep: "Extraterritoriality generally refers to the unilateral use of measures that are taken under a state's sovereign powers to enforce its own law, in a territory other than its own, for actions committed outside its territory by entities or people from other countries" (Jacques Delors Institute 2018).

The threat of extraterritorial sanctions is real, with secondary sanctions having been applied by the US government several times in the past. For example, the Nord Stream 2 gas pipeline was designed to export Russian gas to Germany. Before the war in Ukraine started, the pipeline was heavily promoted by multiple German governments, while strongly opposed by the US and also several Eastern European governments. Similarly, in the context of US sanctions against Cuba, the Helms-Burton Act of 1996 threatens US sanctions against foreign firms trading with Cuban state enterprises.

Secondary sanctions have not been used by just the US. For example, the EU's data protection policy may have similar effects by forcing non-EU companies located outside the EU to comply for their domestic customers with the EU standards, because it is economically too costly or technically too difficult to apply different data protection policies within the same firm. The dominant role of the EU in setting standards is known as the Brussels effect (Bradford 2011). Unlike the previously noted cases, the EU does not require US firms to apply the European standard, but the policy may nevertheless have the same effect of exporting own policies to other countries (see also Svantesson 2014).

When allies do not share the same policies as the country imposing secondary sanctions, policy responses are to be expected and have been taken in the past. I briefly review policy options available, such as special purpose vehicles, blocking measures, and counter measures. Such actions are often limited in its success, however, which establishes the case for investment in strategic sovereignty.

EXTRATERRITORIAL SANCTIONS IN PRACTICE: THE US-IRAN CONFLICT

The history of sanctions by Western countries against Iran is informative about the reason for the emergence

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of extraterritorial sanctions and points to the difficulties in diluting them. The history contains periods in which the US and Europe marched in lockstep, and another when the two sides did not (for a detailed account of sanctions against Iran, see Nazareth 2019 and Gheibi 2022). This raises the natural question as to what induced the latter.

Since the early 2000s Iran's nuclear program became a concern among Western countries. A UN Security Council Resolution in 2006 demanded the stop of Iranian uranium enrichment. Iran refused to do so, and in fact declared its intention to produce highly enriched uranium, which would imply the ability to develop nuclear weapons within a few years. The US had imposed sanctions on Iran much earlier, but the sanction regime became tighter and more encompassing the more Iran's nuclear ambitions rose. Importantly, these sanctions were backed by UN Security Council resolutions, and were narrow in the sense of attempting to limit Iran's nuclear capabilities (Gheibi 2022). From 2010 onwards, the sanctions became more aggressive, now involving Iran's financial sector and targeting its oil revenues (Lohmann 2019).

The sanctions had also extraterritorial reach, but they didn't create a conflict between EU and US because—encouraged by the UN Security Council Resolutions and the fear about Iran's nuclear program—the EU imposed its own sanctions, which banned European investments in Iran's energy sector, cut financial relations, and disallowed European insurers from insuring transport of Iranian oil to foreign markets (Gheibi 2022). The economic impact of these joint sanctions on Iran was significant, and included a steep rise in unemployment, a strong depreciation of Iran's currency, and a rise in food prices. As a result, Iran's leadership changed with the election of President Rouhani in 2013. This paved the way for international negotiations.

In 2015, an international agreement known as the Joint Comprehensive Plan of Action (JCPOA) was reached between Iran and the members of the UN Security Council plus Germany (Gheibi 2022). The agreement included the shutdown of Iran's uranium and plutonium enrichment paths and was to be supervised through international inspections performed by the International Atomic Energy Agency. In exchange, sanctions against Iran were lifted, and Iran was brought back into compliance with international law, as reflected in UN Security Resolution 2231. The economic recovery of Iran was slow, despite the lifting of sanctions, as foreign investors were afraid of new sanctions being imposed again at some later point, which would then make those investments questionable economically (known as "chilling effect").

In late 2016 President Trump was elected in the US. With his election opposition to JCPOA became more forceful, and eventually Trump abandoned the agreement in May of 2018 (Nazareth 2019). The extraterritorial sanctions by the US that existed before the JCPOA were put back in place, even though Iran complied with the inspection regime of its nuclear program. This compliance may have been one reason why European countries did not follow suit and in fact stated that Iran was fulfilling its commitments under the JCPOA.

Interestingly, President Trump referred in his decision not only to Iran's nuclear ambitions, but also to its sponsorship of international terrorism, a point to which I will return below. His decision seemingly justified ex post the hesitation of foreign investors after the JCPOA was agreed to. In other words, the chilling effect was now operative, as potential foreign investors had been right that new sanctions could well arise at a later time. Not surprisingly, the economic fallout in Iran of Trump's decision was massive, with inflation and unemployment rising sharply (Gheibi 2022).

The US decision and its reinstalling of secondary sanctions had severe consequences and exposed Europe as helpless (Lohmann 2019). Firms considering trade with Iran were practically forced to choose whether to trade with Iran or the US, because the US could sanction foreign firms engaged in trade with Iran by blocking their transactions conducted through the US financial sector or by freezing their assets in the US. The EU tried to counteract this threat by creating the Instrument in Support of Trade Exchanges (INSTEX), which was established in Paris in 2019. This is a special purpose vehicle (SPV) that facilitates trade between European and Iranian firms. Since it is a state-run entity, it does not face the same threat as individual firms. US sanctions against INSTEX would be equivalent to sanctions against European governments. However, INSTEX seems to be little more than symbolic and is used for products such as medical supplies that are in any case exempt from the hard sanction regime.

While Gheibi (2022) views US extraterritorial sanctions after JCPOA as counterproductive and unlawful, because Iran was compliant with JCPOA, it raises the question as to why they were reintroduced under President Trump. One may argue that the decision satisfied domestic political interests more than it tried to accomplish something abroad. The literature on (primary) sanctions has recognized that domestic considerations may be an important aspect in explaining their emergence (see Kaempfer and Lowenberg 1988), but this is not the only explanation.

A THEORY OF EXTRATERRITORIAL SANCTIONS

In Janeba (2022), I have suggested an explanation for the use of secondary sanctions that relates to the concern about Iran's sponsorship of international terrorism. It is an explanation for the emergence of such sanctions, not a normative justification. Iran has been involved in funding such terrorist groups as Hezbollah around the world (Kane 2018). Importantly, and in contrast to Iran's nuclear ambitions, it is hard to enforce an international agreement like the JCPOA that would limit Iran's engagement in sponsoring terrorism abroad.

This aspect may explain the use of extraterritorial sanctions by the US ("the sender country"). In contrast to the traditional use of sanctions to change another country's behavior ("the target"), such as changing Iran's nuclear program, the goal of a sender country is rather to limit the amount of resources Iran has available to sponsor international terrorism. Of course, such sanctions make only sense if the reduced resources lead to less sponsorship of terrorism by the target, not more. The latter cannot be ruled out a priori because for political reasons a target country may find it advantageous to spend more on defense and military ambitions rather than less even if its own population is suffering economically.

If lower economic resources reduce sponsorship, extraterritorial sanctions are not used to influence via a stick-and-carrot approach the contractible activity "nuclear program," but rather the non-contractible activity "sponsorship of terrorism:" Iran is deprived not only of export revenues with the US, but also of those with European countries. A statement of President Trump in 2019, in the context of the US pulling out of the JCPOA, is consistent with the relevance of the latter activity: "… the actions of the Government of Iran and Iranian-backed proxies, particularly those taken to destabilize the Middle East, promote international terrorism, and advance Iran's ballistic missile program, and Iran's irresponsible and provocative actions in and over international waters, including the targeting of United States military assets and civilian vessels…" (Executive Order 13876 of 2019).

One may wonder, however, why conventional sanctions jointly levied by the US and European countries did not arise, as in a situation before the JCPOA became in effect. In Janeba (2022) I show that the situation of secondary sanctions by one sender country is a unique equilibrium of a non-cooperative sanction game between two sender countries if there are important asymmetries between the two sanctioning parties, i.e., US and the EU. Specifically, I argue that the fracking boom in the gas sector in the US over the last twenty years (Feyrer et al. 2017) transformed the US from a net energy importer to a small net energy exporter. As Iran's main export good is oil, the US benefits from trade with Iran diminished substantially over the years, while for European countries energy import dependence was and stayed very high, a fact that became painfully clear in the current conflict with Russia after its invasion of Ukraine.

Moreover, I assume that the use of extraterritorial sanctions involves a cost, as such sanctions violate the traditional international economic order, under which trade disputes are typically settled within the World Trade Organization (WTO) according to pre-set rules such as the Dispute Settlement Mechanism. Imposing the US policy on other countries via secondary sanctions therefore involves a reputational cost for the US president and may involve monetary costs due to trade disputes. President Trump looked down on international agreements, exemplified by pulling out of the Paris Agreement on climate change and his "America first" agenda, thus indicating that reputational cost or costs from trade disputes appear to play no huge role. This was different under President Obama, the period before JCPOA, who was more supportive of multilateral approaches.

POLICY OPTIONS AGAINST EXTRATERRITORIAL SANCTIONS

As the European response to US secondary sanctions shows, countries affected by such sanctions try to counteract their negative effects. INSTEX is a special purpose vehicle (SPV) set up in Europe to facilitate trade between European countries and Iran, which would not be affected by US secondary sanctions. Its success was very limited (Lohmann 2019). In theory, it would work because a SPV is a clearing house run by a state entity not subject to such sanctions, and it could allow for trades whose financial transactions would not run through international payment systems like SWIFT or involve US banks. A SPV may also be needed to facilitate legitimate trade such as humanitarian aid that itself is not covered by secondary sanctions but may be negatively affected by the general sanction regime.

The reason why INSTEX had limited success is that even if a European firm that was involved in a legitimate humanitarian deal with Iran operated under INSTEX, it could be accused of violating secondary sanctions in other business activities of the firm (Tilahun 2022). Another open question is whether SPVs are consistent with most-favored-nation (MFN) treatment under WTO law, which requires granting the same market access condition across all trading partners covered by MFN. An SPV could be interpreted as a favorable treatment. If so, other countries could claim to get access to the SPV, such as INSTEX, and if not granted could challenge the SPV as a violation of MFN treatment.

A second instrument to counter extraterritorial sanctions are blocking statutes, which many countries including the EU (Regulation 2271/96, see also European Parliament 2018), Canada (Foreign Extraterritorial Measures Act), and China have in place. Blocking statutes prohibit compliance with foreign sanctions, including non-recognition and non-enforcement of foreign legal proceedings that arise because of foreign sanctions. In other words, the intention of blocking statues is to penalize firms from compliance with foreign sanctions, rather than helping the firms to overcome them via SPVs (Tilahun 2019).

In the context of the US-Iran conflict, European firms have not made use of the rights granted under the EU's blocking statute, perhaps in part because the value that could have been recovered in European courts if a European firm had pursued trade with Iran and been sanctioned by the US is smaller than losing access to the US market. It is therefore unclear whether existing EU law is sufficiently strong to protect European firms. Rather, it may appear that blocking statutes are intended to stop extraterritorial sanctions from being implemented in the first place, so are more political than economic in nature (Tilahun 2019).

Finally, countermeasures are instruments by governments against sanctioning countries that are not tied to the original sanction but rather impose harm on the sanctioning country, such as travel restrictions to persons from the sanctioning state. Of course, trade-related countermeasures are subject to WTO rules and dispute settlement regulations, and as such are more constrained by international law than blocking statutes and SPVs.

POLICY CONCLUSIONS

The rising geopolitical rivalry between the US and China presents not only a military danger to the world. The rivalry may affect in a fundamental way Europe's international economic relations. A confrontational US policy towards China (and vice versa) is likely to spill over to Europe, as the US will try to foist zits trade and foreign policy onto its traditional allies in Europe. While there is increasing skepticism in Europe regarding its economic dependence on China, it is conceivable that European countries, individually or even jointly, may take a different stand than the US. However, Europe may not have that choice if US extraterritorial sanctions were to be put in place. For this reason, it is important for Europe to regain strategic sovereignty (Leonard et al. 2018, European Council on Foreign Relations 2019).

The case of the US-Iran conflict is illustrative in this context. US secondary sanctions effectively shut down European non-humanitarian trade with Iran. European counteractions such as INSTEX and blocking statutes have proved largely ineffective. The relevance of safeguarding access to the US market, or the need to run foreign trade operations through international payment systems like SWIFT or the US banking system, are the reason. In other words, European trade with Iran is too small relative to its trade with the US to effectively counter the threat of US secondary sanctions.

US political and economic relations with China are more complex than those with Iran, as China is economically much more powerful and a much more important trading partner for the US than Iran. The rivalry is economic, political, and potentially military, because of China's ambition to bring Taiwan under its control. The situation is also different for European countries. China is one of the largest trading partners, if not the largest, for several European countries, including export-oriented Germany. For this reason, a European firm's cost-benefit analysis of maintaining trade relations with China versus keeping them with the US is not as clearcut compared to the analysis when it comes to trade with Iran.

At this point it is hard to see that Europe would give up its political and defense alliance with the US to secure economic benefits with China. Nevertheless, Europe is well advised to develop economic tools that allow it to operate more independently of the US (as well as of China), such as in data storage, key technologies such as GPS and network structures, and financial transaction systems, to reduce its vulnerability in case of a further deepening of the US-China geopolitical conflict. The fallout from the US-Iran conflict should serve as a lesson.

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