Senate Banking Committee

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Chairman Crapo, Ranking member Brown, and distinguished members of this committee. Thank you for convening this hearing on such an important and timely topic and for inviting me to testify today.

The scale and range of North Korea’s nuclear and long-range missile programs is advancing by the month, with a corresponding increase in the regime’s threats and defiance. The threat to our allies and to U.S. persons in the region is already too high, and the regime has made no secret of its aim to develop a missile that can reach the continental United States. It is hard to think of a nuclear threat this acute since the Cuban missile crisis. And, despite all of the world’s diplomatic pronouncements, a scenario that has been repeatedly described as unacceptable grows ever closer to becoming reality.

Our response needs to be decisive and firm. It will need to incorporate all of the leverage at our disposal: diplomatic, financial, economic, and military. And it will require the full commitment of our partners, especially those in South Korea, Japan, China, Australia, and the European Union. Ultimately, we must hope that there is a diplomatic solution here, in which the international community negotiates a peaceful and verifiable end to North Korea’s nuclear weapons program.

Currently, the North Korean leadership has no interest in such discussions. If we are to get to negotiations, then, the international community will need to place severe pressure on North Korea until it agrees to come to the table in a serious way. Sanctions will be a key component of that pressure.

Most experts assess – and I agree – that a quantitative increase in sanctions pressure will be insufficient to change Kim Jong Un’s calculus. Even a major drop in North Korea’s export revenues or financial access will not affect his behavior. With a repressive security apparatus at his disposal, Kim Jong Un can weather economic hardship by passing it along to the helpless North Korean people. The only hope we have lies in a qualitatively different and more severe level of pressure – one that threatens Kim Jong Un's hold on power. It would mean placing a stranglehold on the North Korean economy that makes it impossible for the leader to pay his military and security forces, to fuel his planes and trucks, or to provide bribes to his family and cronies. This is a level of pressure far beyond what the international community applied to Iran. In such a scenario, with his government on the brink of collapse, it is possible that Kim Jong Un would come to the table to save his regime.

That said, a number of experts believe that even *in extremis* Kim Jong Un would not negotiate in a serious way. They assess that he would dig in out of a combination of defiance and delusion even if his government risked collapse. I suspect that these experts are right. But if Kim Jong Un will face the collapse of his leadership before he relinquishes his nuclear program, than we need to see his leadership end, whether through a military coup or other means. And severe multilateral sanctions pressure is a route to that end.

The bottom line is, the international community needs to put such pressure on Kim Jong Un that he will either come to the table to protect the wellbeing of his country or be replaced by someone who will. This level of pressure is far higher than where we are today. And, despite some good developments over the last few months, including a strong UN Security Council sanctions resolution, I do not believe that the pressure is mounting at nearly a sufficient rate.

A Renewed Sanctions Campaign

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 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 the regular import 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 cash as well as 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. All three of these elements are needed to prevent a broader economic collapse and to maintain the loyalty of Kim Jong Un's inner circle. A serious sanctions campaign should target all three. It would stifle North Korea's foreign currency earnings – for example by cutting off purchases of North Korea's coal and minerals. It would shut down the front company bank accounts in China and elsewhere that North Korea uses to access foreign currency. And it would constrain the shipment of fuel to North Korea.

China will be the determining factor in such a campaign. 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. In theory, this should be doable. China is not pleased with either Kim Jong Un or with North Korea's burgeoning nuclear and ballistic missile capabilities. China certainly does not like the stepped up U.S. military presence in the region that North Korea has provoked.

To date, the problem has been that, as much as China may dislike Kim Jong Un and his nuclear program, a collapse of the North Korean regime is a far worse alternative. Even an erratic Kin Jong Un is preferable to a government implosion in North Korea, which could 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” and hope for the best.

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 addressing the nuclear problem not regime collapse; and (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. I believe that there is enough overlap between China’s concerns vis-à-vis North Korea and our own for us to work out a mutually acceptable approach and end-game.

Discussions with China will likely require both carrot and stick. We can expect China to take half-steps to increase sanctions pressure but not to a decisive level. Ultimately, the key will be making clear to China that the status quo is not tolerable because of a range of escalating costs, including sanctions exposure.

In approaching questions about sanctions against Chinese entities – especially larger state-owned entities or banks – U.S. policymakers need to be prudent and strategic. Prudent because any larger sanctions would inevitably carry spillover costs to ourselves and our allies. And strategic because, at the end of the day, the objective is to win China’s cooperation, not provoke a breakdown between our nations or a trade war.

There has been much discussion recently about the global economic repercussions of an aggressive sanctions campaign targeting larger Chinese entities or banks. Those who would tell you that we can levy massive financial and economic sanctions against China without serious reverberations for the global economy or businesses in the United States are mistaken. China’s economy and banking system may have been self-contained and insulated against spillover fifteen years ago, but it certainly is not today.

The U.S. has the largest economy in the world and China has the second. Looking at China’s banks, 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 would send shock waves through the international financial system and trigger large and unpredictable fall-out.

Beyond the banks, our trade ties with China are deep and growing. U.S. companies export about $115 billion of goods to China, making it our third largest market after Canada and Mexico. Since 2009, U.S. exports to China have grown about 92%, as compared to 27% growth to the rest of the world. The U.S. exported an additional $53.5 billion in services to China in 2016, a growth of 400% from ten years ago. The Commerce Department estimates that U.S. exports to China support nearly one million American jobs, concentrated in the agricultural, automobile, airline, and financial services sectors.

Beyond any direct trade effects from sanctions, a strong blow to China's banks or economy would put downward pressure on the renminbi and upward pressure on the U.S. dollar. We would essentially be lowering the value of China's currency – a trend that our government has fought for years to combat – with pronounced costs for American manufacturers and exporters and to the many countries around the world that compete with China. And, as former Secretary Robert Rubin has said, "if China really had an economic crisis and as a consequence, the currency plummeted, that would put tremendous pressure on emerging market country around the world to depreciate their currencies, and you can be off to a global currency war."

Finally, the interconnected nature of the global economy means that our economy and our markets face risks if there is a sudden shock to China's economy. We don't need to speculate on this question. Meltdowns in China's stock market during August 2015 and January 2016 were immediately felt in New York. On August 24, 2015 – China's "Black Monday" – the Dow Jones Industrial Average dropped 3.6 percent, while the S&P 500 index fell 3.9 percent. On January 7, 2016, another episode of pronounced weakness in Chinese markets, the Dow Jones Industrial Average fell nearly 2.3 percent, while the S&P 500 index dropped 2.4 percent. These were among the worst trading days in U.S. equity markets in years. Estimates on the global equity market spillover impact from the August 2015 and January 2016 selloffs were on the order of $3 trillion and $2 trillion, respectively. A strong blow to China's economy or weakened banking sector could unleash large capital outflows, triggering a repeat of the August 2015 or January

2016 episodes, or worse. And none of this takes into account the inevitable response and counter-sanctions from China against U.S. firms, especially those with a presence in China.

These are not reasons to walk away from a serious effort to win China's cooperation on North Korean threat. We must do so. But we must be determined as well as prudent.

New Sanctions Legislation

On a final note, I would like to speak to the respective roles of the Legislative and Executive branches in designing and implementing sanctions. The way in which we design sanctions can determine their success or failure. Congress has a key role to play, as I saw firsthand over 13 years at the Treasury Department. From Iran to Sudan to Russia, Congress provided powerful authorities to protect our financial system and to combat foreign threats. That said, in comparison to executive branch sanctions, laws are very difficult to repeal or amend, and sanctions laws have historically been one-way ratchets.

To provide just one example, Mikhail Gorbachev ended the restrictions on the emigration of Soviet Jews in 1989. The Supreme Soviet passed a law codifying this step in May of 1991. In recognition, President George H. W. Bush waived the Jackson-Vanik Amendment's sanctions on the Soviet Union in June of 1991. It took another eleven years for Congress to repeal Jackson-Vanik and, even then, it only did so in an attachment to the Magnitsky Act, which imposed new sanctions against Russia over human rights violations.

I raise this because of a recent trend towards what I see as extreme codification of sanctions, in a bid to strip the executive branch of discretion over the implementation and lifting of sanctions. One recent sanctions bill devotes twenty pages of text to restraining the executive branch's discretion.

President George H. W. Bush was able to incentivize the Soviet Union by utilizing the waiver provisions in Jackson-Vanik, and responded to the repeal of emigration restrictions immediately. The waiver provisions in Jackson-Vanik were designed as guardrails to ensure that the administration faithfully carried out the objectives of the sanctions but they also left the president leeway to exercise his foreign policy auhtorities. In one paragraph, they required that the president determine that the waiver would substantially promote the objectives of the law – in this case freedom of emigration – and that the President had received assurances that the emigration practices in question would henceforth lead to the substantial attainment of the objectives of the Act. If Congress disagreed, it could overrule the president's use of the waiver through a joint resolution.

Had that flexibility not been in place, had Jackson-Vanik tied the hands of the executive branch until the final objectives of the law were satisfied or required an affirmative vote by Congress before the waiver could be issued, the Soviet Union would have perceived these sanctions to be immutable, and the Jackson-Vanik Amendment would not have been nearly as powerful as an inducement to change.

Ultimately, this is what sanctions against states are for. They are meant to incentivize behavioral change. For that inducement to work, the targets of sanctions must see that the president has the ability to lighten or remove the pressure. That is, those that conduct our nation's foreign affairs must have discretion over how and when sanctions are eased or removed. If the sanctions target perceives the sanctions to be fixed, then sanctions have ceased to act as a motivator for change and exist solely as a penalty.

Congress should have a role in crafting sanctions policy. It is, as with many of the aspects of our system that our framers devised, a balance. Where this balance in the separation of powers lies may differ across contexts. In my view, however, sanctions that cannot be eased without an affirmative joint resolution of Congress are not likely to be constructive. Likewise, it is not advisable to impose sanctions that only allow for easing once the ultimate objectives of the sanctions have been obtained. As in Jackson-Vanik, the executive must be able to recognize and reward substantial progress towards a goal, otherwise our diplomats' only available strategy is to negotiate end-state resolutions.

I have witnessed first-hand the power of congress working alongside the president to pursue a sanctions campaign and it is formidable. My hope is that the two branches can work in concert, particularly to address threats like North Korea where objectives are fully shared.

Conclusion

Even with a concentrated and strategic effort across our government, 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, I believe that it is our duty to put all of our energies into this effort.

Thank you again for inviting me to testify.