

**SECONDARY SANCTIONS AGAINST CHINESE INSTI-  
TUTIONS: ASSESSING THEIR UTILITY FOR CON-  
STRAINING NORTH KOREA**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON  
NATIONAL SECURITY AND INTERNATIONAL TRADE  
AND FINANCE  
OF THE  
COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING HOW CHINESE BANKS, BUSINESSES, AND PERSONS PRO-  
VIDE NORTH KOREA WITH DIRECT AND INDIRECT ACCESS TO FINAN-  
CIAL MARKETS AND RESOURCES, ALLOWING PYONGYANG TO EVADE  
OR MITIGATE INTERNATIONAL SANCTIONS

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## **SECONDARY SANCTIONS AGAINST CHINESE INSTITUTIONS: ASSESSING THEIR UTILITY FOR CONSTRAINING NORTH KOREA**

**WEDNESDAY, MAY 10, 2017**

U.S. SENATE, SUBCOMMITTEE ON NATIONAL SECURITY  
AND INTERNATIONAL TRADE AND FINANCE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Subcommittee met, at 10:07 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Ben Sasse, Chairman of the Subcommittee, presiding.

### **OPENING STATEMENT OF CHAIRMAN BEN SASSE**

Chairman SASSE. The hearing will come to order.

I would like to welcome everyone to this meeting of the National Security and International Trade and Finance Subcommittee of the Banking Committee. I am pleased to be joined by my colleague and friend and our Committee's Ranking Member, Senator Joe Donnelly, from Indiana, as well as other Members of the Subcommittee here today, as we seek greater understanding of how so-called secondary sanctions might be used to counter North Korean belligerence and Chinese support.

I am going to offer a more complete opening statement, and Senator Donnelly is going to offer a more complete opening statement later in the hearing. We are going to be a little bit unorthodox in our timing because of some of the things that are happening on the Senate floor this morning that may prohibit the Committee from meeting at some point in the course of our hearing. So even though both of you have excellent opening statements that are filled with content that I think we will want to unpack—I do not think we want them just for the record; we would like to hear longer opening statements from you two—would you be willing to confine yourselves to maybe 3 minutes each just as a kickoff so we can get to some questions from some Democratic Members that are going to be called to another caucus meeting shortly? So I think we will go a little bit out of order in our questioning, if each of you could just have maybe 3-minute opening statements.

Great. I will give very brief biographies of the two of you.

Adam Szubin is currently the senior practitioner-in-residence at Johns Hopkins University School of Advanced International Studies. He is also the former Acting Secretary of the U.S. Treasury Department as well as the Acting Under Secretary of the Treasury for Terrorism and Financial Crimes. Welcome, Mr. Szubin.

Joining him today is the Honorable Juan Zarate, chairman of the Financial Integrity Network, chairman and senior counselor of the Center on Sanctions and Illicit Finance, former Deputy Assistant to the President and Deputy National Security Adviser for Combating Terrorism, and the former Assistant Secretary of the Treasury for Terrorist Financing. Welcome, Mr. Zarate.

Gentlemen, both your written statements will be included in the record later, and after Senator Donnelly and I make statements, subsequently we will let you make opening statements again, but maybe just 2 or 3 minutes from each of you.

Mr. Szubin, welcome and thanks for being here.

**STATEMENT OF ADAM J. SZUBIN, DISTINGUISHED PRACTITIONER-IN-RESIDENCE, JOHNS HOPKINS UNIVERSITY, SCHOOL OF ADVANCED INTERNATIONAL STUDIES; OF COUNSEL, SULLIVAN & CROMWELL; AND FORMER ACTING SECRETARY OF THE TREASURY AND ACTING UNDER SECRETARY OF THE TREASURY FOR TERRORISM AND FINANCIAL CRIMES**

Mr. SZUBIN. Thank you very much. Chairman Sasse, Ranking Member Donnelly, Members of this Subcommittee, it is a true honor to be here. This is my first time testifying outside of the Government. I think it is fitting given our relations over the 13 years I had in Treasury, and it really is an honor to be back.

I am often asked a pretty core question at this moment, which is whether, as with Iran, the international community could generate enough sanctions pressure to force a North Korean Government to the table to negotiate a peaceful and verifiable end to its nuclear weapons program. It is obviously an immensely difficult question, but I do believe the answer is a qualified "yes."

Let me just share my top-line assessments, and then I will obviously yield in the interest of time.

First, North Korea is not self-reliant or "sanctions-proof." Its leadership depends upon access to foreign imports and international banking services, and that access can be disrupted.

Second, 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 chance to succeed. If not, they do not.

Third, despite years of high-level international attempts, China has thus far resisted more than incremental enhancements to its sanctions posture. China does harbor serious concerns about Kim Jong-un and their nuclear program, but a collapse of the North Korean regime and the chaos that it would unleash on China's border poses a far greater threat in China's eyes.

For that reason, U.S. sanctions alone will not force China to adopt a sufficiently aggressive approach no matter how draconian and costly those sanctions become. China will not be strong-armed into a course of action that it believes imperils its own national security.

For that reason, serious and high-level engagement with China will be needed to set out a way forward, to include an intensive pressure campaign, and the various scenarios that could follow from it, including potential leadership change in North Korea.

China will not roll the dice when it comes to the fate of its impoverished nuclear-armed neighbor. Concerns over stability will be paramount, but I believe that our interests can be reconciled with China's.

What is needed here is a massive diplomatic investment and multilateral engagement to marshal a campaign, including China and other countries around the world, both the like-minded and the resistant. Having participated in a comparable campaign with respect to Iran, I would urge both the Administration and Congress to staff key leadership positions at the State Department and the Treasury Department quickly, including confirming Sigal Mandelker, who has been nominated to serve as the next Under Secretary for TFI. I know her to be an intelligent, experienced, and strong leader. 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.

To conclude, even with a concentrated and strategic efforts, we obviously cannot guarantee that a diplomatic effort powered by new sanctions pressure will succeed, but I believe that it has a real chance to do so, and I am not aware of a better alternative. Faced with this ever-growing menace, it is our duty to put all of the considerable talents, intelligence, and energies of the U.S. Government behind this effort.

Thank you again for having me to testify.

Chairman SASSE. Thank you, Mr. Szubin.

Mr. Zarate.

**STATEMENT OF JUAN C. ZARATE, CHAIRMAN AND CO-FOUNDER, FINANCIAL INTEGRITY NETWORK; CHAIRMAN AND SENIOR COUNSELOR, CENTER ON SANCTIONS AND ILLICIT FINANCE; FORMER DEPUTY ASSISTANT TO THE PRESIDENT AND DEPUTY NATIONAL SECURITY ADVISER FOR COMBATING TERRORISM; AND FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TERRORIST FINANCING**

Mr. ZARATE. Chairman Sasse, Ranking Member Donnelly, and distinguished Members of the Subcommittee, it is really an honor to be here today. Thank you for the invitation. I will tell you it is an honor to be testifying next to my very good friend, former colleague, and one of the great professionals in this field, Adam Szubin, somebody for whom I have enormous respect. And I expect him to take all the hard questions, Mr. Chairman.

[Laughter.]

Mr. ZARATE. Mr. Chairman, as you and I discussed and as we know, this is a timely and important hearing. What was once seen solely as a threat from North Korea to peace and stability on the Korean peninsula and in the region has now become a looming, potentially direct threat to the U.S. homeland. All the while North Korea tests ballistic missiles and increases the pace of its nuclear program, it is also proliferating its technology for profit, engaging in illicit finance and commercial activity, exploiting forced labor and human rights abuses to make money for the regime, and even using cyber tools to attack financial infrastructure.

This is also a moment to challenge the orthodoxies because of the urgency of the task at hand, and I agree with Adam that this is a moment to think about a renewed financial pressure and economic campaign against North Korea that has as its centerpiece the change in the Chinese calculus with respect to their interests.

Now, this is not easy. The Chinese have been pressured in the past. They have showed glimmers of wanting to cooperate, including recent rejections of coal imports from North Korea. But the Chinese have a different strategic interest, and our interests and theirs have not aligned with respect to the use of financial pressure in an existential way against the regime in Pyongyang.

I think this is a moment for China to assume its role as a great power, to be able to influence its North Korean ally. This Administration and this Congress will have to grapple with how best to obtain, to a certain extent coerce, and sustain Chinese cooperation in order to maximize pressure on North Korea. And, ultimately, we have to change the calculus in Pyongyang to either slow or stop the pace of its nuclear program.

But the linchpin here is the Chinese calculus. Unfortunately, this has been the third rail of the sanctions debate. There has been an uneasiness with a willingness to pressure China or to pursue efforts that touch the Chinese economy or Chinese interests too directly. I think that calculus has to change. In many ways, China becomes the linchpin for these efforts, and as we see with all of the illicit networks that are exposed, there is inevitably a Chinese link, Chinese facilitation, Chinese networks, Chinese agents.

Any effort, whether it is to apply secondary sanctions, which would apply to those actors that are not doing business directly with the U.S., do not have a U.S. nexus, or other financial measures, has to put at risk Chinese interests, or at least make clear that Chinese interests are going to directly or indirectly be impacted by their relationship with North Korea and the illicit activity engaged in. And I would argue, as my testimony lays out in greater detail, that secondary sanctions are only one part of a panoply of steps that can be taken to sensitize the environment, to make the reputational risk and the real risk of doing business with North Korea ever more dangerous, ever more difficult for the Chinese. The more the Chinese realize that their interests are directly impacted by what North Korea is doing, be it on the nuclear file, on the missile testing program, on the illicit financing activity, the more likely it is that the Chinese will change their behavior and change their calculus.

As I said, China has the opportunity to prove its role as a great power and to use its influence with Pyongyang. The clock is ticking in many ways, and an effective financial pressure campaign with China on side is one way of potentially helping to slow, if not stop, the clock.

Thank you, Mr. Chairman.

Chairman SASSE. Thank you, Mr. Zarate.

Senator Donnelly has agreed to temporarily defer to Senators Heitkamp and then Cortez Masto. Senator Heitkamp.

Senator HEITKAMP. Thank you so much, Mr. Chairman. This is a Committee that I had the honor of being the Ranking Member on last Congress, and I will tell you it tends to be incredibly bipar-



tisan. And I want to pledge to both of you my support and anything that I can do as you advance this discussion and this agenda, because nothing is more important. Really, it is incredible that the Banking Committee has this responsibility, and it is a responsibility that is absolutely critical to national security.

I want to turn to Mr. Szubin and Mr. Zarate. I want to say just on the record that for some reason the job that you two have held attracts absolutely the best and brightest in public service in America, people whose intellect and capability could be earning riches on Wall Street, but yet you serve our country in this very strategic and absolutely essential role of monitoring and implementing sanctions. And I want to thank both of you from the bottom of my heart for your public service. You are true patriots, and your appearance today reinforces that.

I think there is a lot of cynicism—Mr. Szubin, I am going to start with you. There is a lot of cynicism about whether you can, in fact, achieve this result without China participating and a lot of cynicism about whether China will play the role of, yes, we are on board, yes, we are on board, but yet we do not see the kind of activity that we need to see given the regional threat that North Korea presents.

North Korea's interest is obviously in preventing regime change. You know, that probably is pretty consistent across the board in all of world Governments. But this is a very dangerous regional development, and I am wondering, how do you assess the likelihood of success that China will, in fact, play a critical and important role going forward?

Mr. SZUBIN. I think that is the question of the hour, Senator Heitkamp, and—

Senator HEITKAMP. But I wanted an answer, not a repetition of the question, Mr. Szubin.

[Laughter.]

Mr. SZUBIN. I am not going to be repeating the question. I would not dare.

I think we have a chance, and as I put forward in my written statement, China does not start with an opposing set of interests to our own here. China, I think, is made quite nervous by the behavior of this young dictator in Pyongyang. He has gone out—

Senator HEITKAMP. Can I ask you, do you think they feel the urgency that we feel at this point?

Mr. SZUBIN. Probably not quite, and Kim Jong-un has called out the U.S. as his leading enemy and has a stockpile of nuclear weapons. So, of course, we feel that urgency in a different way from China.

But China, I think, would be very glad to see a solution to the nuclear threat to global security. It comes with a lot of headaches for China, including the deployment of THAAD in South Korea and a lot of military attention from the U.S. right off of China's shores. On top of that, I think China would be happy to see a more stable leadership posture out of Pyongyang.

So we have a lot of shared interests, but right now the key impediment, I think, to further Chinese cooperation is their fear of a regime collapse. And a regime collapse is a much greater threat to China given the level of poverty in North Korea, the level of chaos

that would unleash right on their border, than anything else that we are talking about today.

So this is the key conversation to be had between really senior members of our Government and China's Government, is not just how do we turn the pressure up, how do we start pushing toward nuclear negotiations, but what does that pressure look like and what are the next three steps after the pressure gets that high, because China is not going to head into this without knowing those answers.

Senator HEITKAMP. Do you think secondary sanctions will be viable in this situation?

Mr. SZUBIN. I think secondary sanctions ought to be considered if the need arises, and the reason I put it that way is they are just a sanctions tool like any other. We saw in the Iran context how powerful they could be, but they were marshaled to a broader strategic efforts with diplomacy that was really substantial over a period of years, and they followed on to a series of primary sanctions moves that really had Iran quite isolated.

So at the right time, as part of a strategic diplomatic campaign, secondary sanctions may be needed in this context. But I do not think that time is now.

Senator HEITKAMP. OK.

Mr. SZUBIN. I think they need to be—they need to be linked to a campaign and not be set out in advance of a campaign.

Senator HEITKAMP. Mr. Chairman, I want to be respectful of your great generosity, so I will close there. But I can expect that we will be able to file some written questions.

Chairman SASSE. Absolutely. Thank you.

Senator HEITKAMP. Thank you, Mr. Chairman.

Chairman SASSE. Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you, Mr. Chairman and Ranking Member. I appreciate that.

Can I follow up then? Because this was a similar line of questioning that I had as well with respect to secondary sanctions. I am going to pose this to both of you. What do you both understand to be the Trump administration's strategy to halt North Korea's missile program and the role that the secondary sanctions should play?

Mr. SZUBIN. I cannot speak, Senator, to the Trump administration's strategy here. Obviously, I am now on the outside and am not a part of those discussions. I was a part of the last two Administrations' discussions on North Korea, and typically there is a focus on how do we turn the pressure up to a level where North Korea is forced to the table in a way that they have not yet been to date to engage in multilateral negotiations over their nuclear program. That is obviously a very tall order.

Senator CORTEZ MASTO. And part of that is making sure we, like you said, completely staff up the State Department and putting that pressure on through diplomatic channels. Isn't that correct?

Mr. SZUBIN. That is absolutely right. And it was essential in the Iran context. There is a lot of attention that is given to the work of our former office, the Treasury Department, the intelligence agencies, in terms of getting really effective, crippling sanctions in place on Iran. And what is sometimes neglected is how much diplomatic outreach was needed to make those sanctions work and to

make them stick. That was hundreds of thousands of hours of visits to different capitals, everywhere from Azerbaijan to Singapore, to ensure that bankers, traders, and regulators were enforcing the sanctions in a tough, meaningful way. And it was a huge effort that requires diplomacy.

Senator CORTEZ MASTO. OK. Mr. Zarate.

Mr. ZARATE. Senator, obviously I am not part of the Administration, but I think you can divine two core themes and changes in the Trump administration policy in North Korea. The first is a sense of urgency with respect to this issue. You have heard Director Pompeo from the CIA talk about this. This is now an urgent direct problem that is being treated as a front-burner national security issue, which is adding diplomatic attention and urgency to the issue.

The second is placing the onus squarely on China to try to resolve these issues. Even the President's tweets have been, I think, an attempt to do that in perhaps a clever way. But, in any event, I think the overarching theme is, Can you persuade China in a cooperative way to influence North Korea in a way that they have not to date? And I think that is the overarching thematic change.

How they go about doing that, whether or not secondary sanctions should be a part of that, I think is yet to be seen. I have not seen an articulation of this from the Administration.

Where I would agree with Adam, but then also disagree, is there is no question this has to be part of an overarching strategy. It has to fit into a strategy. We have to understand what we are trying to achieve with the financial and economic measures and use the full complement of them and choreograph them properly.

Where I perhaps disagree slightly is I do think this is a moment to actually have the secondary sanctions in place, not to necessarily apply them, but to have the authority available both to signal to the marketplace that this is a potential risk of doing business directly or indirectly with North Korean entities, and also to begin a signaling mechanism, a financial diplomatic message to Beijing that we are upping the ante, that this is a more urgent, a more serious dimension of how we are going to do this. This is not going to be how we have treated the Chinese dimension of North Korea in the past.

And so I think, at a minimum, as a signaling mechanism, it is incredibly powerful, and it begins to open the aperture for diplomacy, for discussions with the private sector, for targeting of actors, and we see over and over again—the *Wall Street Journal* just this past weekend revealing ties between known Chinese entities with a presence in the U.S. and North Korean agents and networks. Those are the kinds of things that will be accelerated and exposed if you have secondary sanctions plus other measures in place.

Senator CORTEZ MASTO. And following up on that, and I just have a minute left, but as we talk about secondary sanctions, do you see a difference between applying that pressure on smaller Chinese banks versus the larger Chinese financial institutions and what implications that means for our financial market?

Mr. ZARATE. I think secondary sanctions applied to the Chinese banking system, it is very difficult, for three reasons, and Adam

lays this out very neatly in his testimony. But I think the first is the Chinese learned a lesson after 2005 when we applied Section 311 authorities against Banco Delta Asia where the major Chinese banks, to include Bank of China, had exposure to North Korea. And so after that lesson, they realized it was probably not a good idea for the four major banks in particular to have exposure to North Korea.

And so what you have seen since then has been a concentration of the kind of financial and commercial activity with North Korea, especially in the northeastern part of the country, concentrated with smaller institutions, smaller brokers, money service businesses, in a way that has isolated that activity from the major banks. That means there is less connectivity to the U.S., and secondary sanctions are most helpful when there are entities being targeted that want access to U.S. markets or facilities.

The fact that that is the case, though, does not undermine the credibility and strength of the potential secondary sanctions for two reasons. One is you have unknown connections to North Korea still, and even these institutions, these big four Chinese banks, may not understand or may not even see the exposure that they have to elements of the North Korean network. So that is one issue.

The second is secondary sanctions are going to apply not just to banks but to other commercial actors, and at a time when China is very much trying to expand the reach of its banks—I just got back from the Southern Cone where, you know, you see the big towers of the Chinese banks in places like Buenos Aires and Santiago, Chile, and they are worried about their commercial brands around the world, Huawei and others. The reputational risk attached to what North Korea represents across the board is quite significant.

Maybe if I can leave you with this one thought: We have consistently underestimated the power of these tools, leveraged properly and appropriately with diplomacy and strategy, but I think we have to test and probe whether or not these tools can be used in a more aggressive form to change the Chinese calculus, because I actually think we can. And I think if it is done well and smartly, we can change the dynamics.

Senator CORTEZ MASTO. Thank you. Thank you very much.

Thank you, Mr. Chair.

Chairman SASSE. Thank you. Senator Donnelly and I will return to opening statements at this time.

Just very briefly, we are obviously here because of new threats from an old foe. Since 1950, North Korea has been an aggressive and disruptive player in Asia, and its new leader, Kim Jong-un, appears committed to continuing and extending this tradition.

After assuming leadership of the hermit kingdom in 2011, Kim Jong-un has oppressed his own people, killed his real or perceived opposition both inside and outside North Korea, provoked and attacked our South Korean allies, and even threatened to strike the United States with a nuclear weapon. To the comments that have been made, there is not a more critical global national security issue than this. This is crazy and cannot be allowed to continue.

Earlier this week, Pyongyang even referred to our colleague Senator Cory Gardner as “human dirt” and accused him of having lost not only all human judgment but also all body hair. I have no idea what that meant.

Kim Jong-un’s patrons in Beijing have him on a very long leash. His behavior, at least in part, is enabled by numerous Chinese institutions and individuals who allow North Korea to bypass the international sanctions regimes that exist by providing them with both direct and indirect access to international markets via shadow banks, illicit networks, and other illegal mechanisms.

That brings us to the point of today’s hearing and I think the two central questions before us, and they are: Is it possible and is it advisable to employ secondary sanctions against these Chinese institutions and individuals in an effort to further turn the sanctions screw against North Korea? And as the three of us discussed prior to today’s hearing, I think we will probably toggle across three different topics. One of them is that most narrow proximate question of should the U.S. Government move toward secondary sanctions, and should the Senate and the Congress be moving to give new tools to the Administration to advance that agenda, to take action against these Chinese institutions that are enabling North Korean behavior? Bucket one.

Bucket two, where does North Korean international money come from? What percentage of that is Chinese? And what do we know about the decision-making processes inside China, which would then further enable the Senate and the Congress and the Administration to make calculations about whether or not North Korean behavior could be influenced via secondary sanctions against these Chinese institutions?

And then third, and more broadly, a whole range of questions that the two of you, given the expert positions you have held in the past, might be able to bring to bear and use to tutor us on analogous situations in the past about how secondary sanctions regimes work in situations that might be analogous in some way to this? So I look forward to both of your testimony.

Senator Donnelly.

#### **STATEMENT OF SENATOR JOE DONNELLY**

Senator DONNELLY. Thank you, Chairman.

I want to start by thanking the Chairman for calling this hearing. North Korea poses one of the most dangerous and pressing threats to the United States’ national security. We have to dramatically increase our diplomatic and economic pressure on the regime to abandon its nuclear weapons.

I also want to join the Chairman in welcoming our witnesses. You are extraordinary leaders for our country. You have done amazing work to keep our citizens safe, and that is why we have turned to you today, is because of the faith we have in both of you. You have an admirable record of public service and formidable expertise on the subject at hand.

Today’s hearing will tackle the critical question of whether and how we can reverse decades of failed efforts to counter the North Korean threat. There are two key points we should emphasize, I think.

First, the common perception that North Korea is just a hermit kingdom, cutoff from the global economy and international financial flows. That is deeply misleading. North Korea does billions of dollars in international trade, and North Korean exports nearly tripled in value in the last 9 years after the first U.S. sanctions were imposed. As those sanctions have escalated, North Korea has responded by developing evasion techniques that are increasing in size and sophistication.

Second, China is the linchpin. They are the key to any international sanctions efforts. They account for more than 90 percent of North Korea's trade. While there has been some limited progress in China's participation in international sanctions, they must do more if we hope to have an impact on Kim Jong-un's strategic calculus.

Secondary sanctions are a logical tool for pressuring China to do more, but a tool that must be wielded carefully, and I look forward to hearing your views and recommendations on that topic.

I will close by saying that as the Ranking Member of this Subcommittee, which deals with U.S. and foreign nuclear forces as well, I have studied the situation in North Korea closely and been briefed on options for U.S. military action. Those have been some of the most sobering briefings of my career, and I pray for the sake of our armed forces and, frankly, the world that we will never have to put those plans into action.

I am concerned that we need to focus on this critically, as we are trying to do today, and I hope this hearing will help lay the groundwork for cooperation between Congress and the White House that we tackle this threat together, not as Democrats and Republicans but as Americans making sure that everyone in our country and all of our friends and allies are safe as well.

Thank you, Mr. Chairman.

Chairman SASSE. Thank you, Senator Donnelly, and I would like to publicly thank you as well for the work that we did in preparing for this hearing. There is a long tradition that this Subcommittee has been very bipartisan and nonpartisan. One of the places that the Senate works much more effectively that is not always that visible to the public is when we are in the SCIF together getting briefings. There is much less awareness of people's partisan labels when they are in there being briefed on national security and global security issues. And the Ranking Member and I have been briefed on these topics both here on the Hill and in a SCIF at the White House on some of these topics. And when you are there, they are not really Republicans and Democrats. They are American patriots who are worried about the future and whether or not we have a clear enough strategy.

So I know that both of you have conducted yourselves that way across the last two Administrations, and so we are grateful for your time.

Earlier we gave you truncated opportunities for opening statements. I want to give each of you the opportunity to expand a little bit if you would like and if you do not have anything that you want to pull directly from your statement. And, again, thank you for both of them. They were long and meaty and helpful tutorials for us.

I think it would be useful then maybe for you to also give us a sense of if you were going to give us—for our colleagues who either were here briefly or will not attend today’s hearing, if you were going to give three or four takeaways of what you would like Senators on the Banking Committee to understand about the sanctions options before us with regard to North Korea, I think we would love to have your takeaway insights as well as anything you want to extract from your opening statement. Mr. Szubin.

Mr. SZUBIN. Well, thank you very much, Chairman Sasse, and thank you to both of you for the kind words and, to Ranking Member Donnelly, for your support. I was a recipient, a beneficiary of the bipartisan support of this Subcommittee and the Committee as a whole in my years at Treasury, and that bipartisan support unquestionably made for a stronger sanctions posture and allowed our sanctions to have a massive impact abroad. It was not seen as a wedge issue; it was seen as a united front. And I very much hope that continues.

I do not need to pull more from my written testimony, but I do want to come back to, I think, the central issue of the day. I think Juan and I are actually extremely close across the board on the need, first, to put this issue front and center with China. There are so many issues that we deal with when it comes to that bilateral relationship, whether they are economic, trade, currency, whether they have to do with geopolitical issues, the South China Sea. And I think it is time, if not past time, to put this issue as our paramount priority. China needs to understand that this is not one among many. This is first. And an intensified sanctions campaign I think has to be part of that. It is not that I think we need to be cautious when it comes to sanctioning Chinese entities. The caution I was talking about was before deploying a new stage, which is secondary sanctions, but there is quite a lot of authority and heft to the tools that the U.S. Administration has right now thanks to Congress to go after North Korea’s activity in China and elsewhere, just using the current authorities on the books. And I would like to see that stepped up, and I would like to see the diplomacy and the high-level diplomacy with China stepped up.

In terms of the when, to my mind, we need to be guided by Secretary Tillerson, and when there is a signal from the Secretary of State that these tools would be net more helpful at this point to unsheathe than damaging, then I think that is the right time. And it is going to be very difficult for me as an outsider or for any outsider to judge where we are in the conversation with China.

But I do agree that it is not just going to be a carrot conversation. There is going to have to be both carrot and stick.

Chairman SASSE. Mr. Zarate.

Mr. ZARATE. Mr. Chairman, thank you, and I want to thank the Ranking Member as well for the kind thoughts and echo Adam’s thanks.

I do think Adam and I are closely aligned. There may be some nuance in opinion here as to how to think about this, but, you know, maybe I can provide three insights, pulling a bit more from the testimony. And, Senator Donnelly, you pointed to this.

I think one thing this Committee needs to continue to be an evangelist for is the idea that the orthodoxy that North Korea can-

not be impacted by financial and economic measures is just not true; in addition to the idea that we have sanctioned ourselves out of doing things to North Korea, that is not true either.

And so just the very notion that we should be thinking creatively about what those tools and strategies could look like is really important. It is the point of this hearing, and I commend the Chairman and Ranking Member for calling this.

At the same time, these measures are not silver bullets, and I think one of the follies of some of the literature and discussion around these issues and the role of sanctions, especially in the wake of the relative success on Iran, which credit Adam and Stuart Levey and Danny Glaser and Chip Poncy and others, is the fact that when you are dealing with fundamental issues that relate to regime survival, which is really what we are talking about with Pyongyang, sanctions alone and as a stand-alone strategy and campaign will not do it. There has to be a collection of tools and influence that are brought to bear, including with respect to the Chinese calculus. The Chinese calculus is not going to be altered simply because one of the Chinese banks is threatened with a sanction by the U.S. That is not going to alter fundamentally their position. So it has to be a collective set of strategies and tools that are brought to bear.

Where I maybe differ with Adam a bit—and this is where I have been somewhat critical with sanctions policy in the past—is I think we have got to get away from the idea that sanctions need to follow neatly from the diplomacy we are engaged in, and the financial pressure campaign has to be sort of geared toward moments of diplomacy. I think one of the problems of our North Korea policy to date has been that we have been in start and stop mode. At every moment of a new test, every moment of North Korean belligerence, we then impose new sanctions. We then think about a new stage of pressure.

I think we have to think differently about this. I think we have to have a constant and consistent pressure campaign that in some ways is parallel and complementary to our diplomacy, but independent from those stages of diplomatic discourse. And part of the reason you want to do that is to make these tools effective, you actually have to condition the environment. They have to be used consistently. You have to weed the garden at all times, and you have to continue to up the pressure. That is in part what the success of the Iran campaign demonstrated. It was a consistent set of actions that over time constricted the Iranian economy. That is what works. In this case, you have less time. In this case, the dynamics are different. But, in any event, you need a consistent pressure campaign.

And, finally, I think the one thing that this Committee could help drive is creativity and imagination around how you change the Chinese calculus. I think one of the orthodoxies we have had all along is that the interests are too divided, that the Chinese cannot be influenced. I do think there were glimmers in the past of Chinese interests changing or their calculus being altered by their own self-interest. This is not a matter of getting them to want to advance U.S. interests. It is a matter of affecting fundamental Chinese interests. And when it comes to the health and security of



their banking system, their economy, this is critical. The Politburo just last month held a study group, issued a study group on financial security. This matters to the Chinese. They worry about human rights and human rights blowback and reflection on them. That is a connection to the North Koreans that they do not like. They worry about corruption and the taint of corruption tied not only internally but also to North Korean activity. That is a lever to use.

And so there is a whole dimension of things that the Chinese care about fundamentally that we can then use as levers, not to attack the Chinese but to demonstrate we are going to pressure the North Koreans. And if it happens to affect the Chinese and Chinese interests, so be it. And I think this Committee can help, especially with this hearing, to drive the opening of that imaginative aperture to think about what those tools are.

Chairman SASSE. Thank you. Very helpful.

We are going to go to Senator Rounds.

Senator ROUNDS. Mr. Chairman, first of all, thank you for holding this Subcommittee hearing today, and thank you for the courtesy of allowing me to step up in line in the timing.

As you know, gentlemen, in 2012, the U.S. Treasury sanctioned the Bank of Kunlun, a Chinese bank, which was one of two foreign banks subjected to secondary sanctions under the Comprehensive Iran Sanctions and Divestment Act, or CISADA, which was due to significant transactions with sanctioned Iranian banks.

My question is: Did the U.S. Treasury action adversely affect the U.S.–China relationship?

Mr. ZARATE. Senator, based on my knowledge, not at all. There were certainly diplomatic objections from the Chinese, but at the end of the day, based on what I know from the outside, based on what David Cohen, the former Under Secretary of the Treasury, has written, the Chinese actually told Kunlun Bank to stop its activities. Kunlun Bank remains designated under that authority. I do not know what the current status of its activities looks like, but the Chinese certainly objected diplomatically, but they reacted the way that we would have hoped. That also matched the activities and their reaction in 2005 when the Treasury designated Banco Delta Asia in Macau as a primary money-laundering concern, where there was a lot of diplomatic objection and tension and arguments that this was an infringement on their sovereignty based on a unilateral U.S. action. But at the end of the day, they wanted to protect their reputation; they wanted to protect the perceived integrity of their major banks; and they cleaned up the North Korean activity that was at least present obviously in places like Bank of China and some of the other major banks.

Senator ROUNDS. Mr. Szubin.

Mr. SZUBIN. Thank you, Senator. Having been on the inside—and I do not want to talk about internal diplomatic conversations—certainly it was a sensitive issue in the run-up to that. It is an issue that we broached with the Chinese repeatedly to share our concerns about what was going on with Bank of Kunlun, such that when the sanction was actually taken, it did not come as a surprise. And I think there were steps then taken by China to be able to address the conduct, as Juan has said.

But we also have to distinguish between a bank like Kunlun, which is a tiny regional bank that had next to no dealings with the U.S. markets and the U.S. dollar, and, you know, one of the largest banks in China at the other end of the spectrum. Right now, the four largest banks in China are also by assets the four largest banks in the world. And their dealings in the U.S. dollar, their investments in the U.S. and in the international markets are substantially different from what we are talking about with Bank of Kunlun. And the evidence for that is Bank of Kunlun continues to exist even having been subjected to secondary sanctions. It was not a death sentence for Kunlun Bank. Kunlun Bank was happy to tailor its services to Iran and other secondary or tertiary players.

I do not think we need to shy away from pressuring Chinese banks over conduct with North Korea. To the opposite, I think we need to very much hold their feet to the fire. And I think we need to hold the feet of the Chinese Government to the fire.

One of the other differences, though, from the Iran campaign to the North Korea situation is Iran conducted and still conducts its banking business like a country. It opens correspondent accounts for its major banks in other major banks, and then it routes its commerce in foreign exchange through those correspondent accounts.

And so you had a pretty easily identifiable set of access points that could be turned off and that we were going around the world, frankly, urging countries to turn them off. And Kunlun did not comply. Kunlun faced secondary sanctions.

North Korea does not conduct its banking business like a country anymore. It conducts its financial business overseas like a criminal cartel, frankly. It uses front companies, so there is no correspondent account for the second bank of North Korea that is open that a Chinese bank could just turn off. What is required is sort of a criminal forensic and intelligence full-court press to ferret out who those front companies and agents are and to shut them down and then to continue to turn the screw, because North Korea will not sit still to just watch its access points cut. It will find new access points.

For that reason, I am not only describing what will need to be a very intensive push by our Government, but also by China on the enforcement side, and by Chinese banks. We need to somehow enlist their cooperation, and that might involve some arm-turning, twisting. It might also and I think necessarily will involve discussions about where this is all headed.

But through a combination of devices, we need to get China to care about this issue nearly as much as we do. Otherwise, we are not going to succeed in that cat-and-mouse game of forcing North Korea's dirty money out of China.

Senator ROUNDS. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman SASSE. Senator Donnelly.

Senator DONNELLY. Thank you, Mr. Chairman, and I want to thank both the witnesses.

You had talked about getting their attention, that this is critical to us. And if you had two or three key ideas that you said here are

the two or three that I would say do most, to each of you, what would they be?

Mr. SZUBIN. If I were advising the Secretary of State, I think the conversation that we are having today, the focus of Congress and this Committee on secondary sanctions, could be an extremely useful opening to the type of very serious conversation that I think they want to have and that we need to have.

Senator DONNELLY. And what do you think would be the first secondary sanctions that you would say this would be critical and this would be critical?

Mr. SZUBIN. I am talking here about the threat on the horizon that Congress seems to be headed in this direction, that we, the Administration, may not be able to stop them, and there is always this sort of good cop/bad cop routine that plays out with diplomacy. When those secondary sanctions come into effect, we want to see major Chinese banks with clean hands, not having any North Korean dirty accounts on their books, so that this is really going after the small rogue actors as opposed to the international-facing, most reputable, first-tier banks in China.

So, to me, that is a conversation that I think could bear real fruit right now, and you do not need to enact secondary sanctions to have it.

Senator DONNELLY. Mr. Zarate.

Mr. ZARATE. I think Adam is absolutely right. I think the mere threat of secondary sanctions and the potential to have a conversation with the Chinese to say, "Look, this is not intended to attack your entire banking system, nobody wants that." What we are trying to do is identify rogue, illicit financial behavior, activity that violates international norms and principles, to which China subscribes, at a time of heightened expectations globally about what the banking world is supposed to be doing. We have all seen the billion dollar fines of the major global banks around the world. This is a time of heightened expectation with respect to transparency and accountability and traceability in the international financial system. This is a demand of the Chinese system, and to Adam's point, I think putting that conversation to them is very important. And I would say that could be amplified and suggested to them in very material ways.

So I think in addition to potential secondary sanctions, you could use Section 311 of the PATRIOT Act yet again. Section 311 has been used against the jurisdiction of North Korea and financial institutions from North Korea. But as Adam said, it is very hard to play Whack-A-Mole with the North Koreans. They are changing names, they are changing shipping registries, they are changing agents all the time. So that is difficult, and that is not the most efficient way.

Senator DONNELLY. A lot of the times in our country, some of the smaller banks work with the larger banks as—they are kind of like the fortress bank for them. Does that go on in China as well? And is that the kind of thing that we can look and say, look, you have this bank, this one, this one that are all involved in North Korea, and you are the ones that they work through? Is that something that would help?

Mr. ZARATE. Absolutely. And, in fact, when I mentioned the indirect risk to the major Chinese banks, the four major global banks, that is exactly what I was referring to, which is their own counterparty and affiliate risk that exists given their connectivity within the Chinese system, again, that they may not even be aware of. We have seen this with responsible Western banks that often do not understand what risk even exists within their systems or their account holders. So there may be this risk.

And so the conversation to be a legitimate one, to say, look, you need to understand as a responsible international player, as a responsible bank, where you have this risk. And whereas going with the 311 was exactly this, Senator, which is to have a Section 311 action that designates all North Korean financial and commercial activity as a class of transactions that is a primary money-laundering concern. This is not about a particular financial institution. It is about anything that touches the North Korean system or any potential transaction.

What that does is it forces responsible banks to actually have to do a lot more due diligence, a lot more investigation around what their risk looks like, and that in some ways is marshaling then the major Chinese banks which have an interest in doing this right, or at least not being affected by the reputational taint, to do this.

Two other quick ideas, though, I think are important. I think we should launch an anti-corruption initiative using the anti-kleptocracy resources that the prior Administration put in place, some of the efforts that the Bush administration put in place when I was at the White House, to actually make the issue of corruption on the part of the North Korean regime something that is somewhat dangerous and potentially revealing on the Chinese side. That would get the Chinese attention given Chinese internal dynamics on corruption. So having a focus on corruption itself in the North Korean context has a potential to impact Chinese thinking about their threats.

The last thing I would say on shipping, I think we can do a lot more—and you have seen this from the private sector—to map the networks that are used by North Korea to proliferate and to engage in activity. The reason that is interesting and important is that inevitably reveals the financial networks, the conduits that they are using throughout Asia, especially in China. It also raises the specter of a more aggressive interdiction campaign, perhaps by the U.S., South Korea, Japan, Australia, where maritime resources are going to be in places that the Chinese are not going to be very comfortable with. And so my argument here is let us use elements of international norms and principles that the Chinese and Chinese responsible entities are going to be sensitive to to actually begin to shift Chinese calculus and behavior. And if you did things like that—and there are other ideas in my testimony, and I know Adam has other ideas, too—I think you could begin to reshape the way the Chinese think about this. This is actually more of an existential risk to them as a responsible global player than ever before.

Senator DONNELLY. OK. Thank you.

Chairman SASSE. Senator Perdue.

Senator PERDUE. Thank you. And thank you, guys. I think this is an extremely critical topic at a really tough time right now.

I have got a question about the validity of the sanctions, and I am concerned about that the game has changed. Mr. Zarate, you brought up Banco Delta Asia in your testimony, and you talk about it being an example of how sanctions work. My question is that things have changed since that time. You know, China is seeking an alternative to the U.S.-created global system. And so with their growth and our debt and our negative current account, their trade conversations over there with their consortium they are trying to build, do you think that these sanctions today would have the same pressure on these financial institutions that it did in the past? Or would this begin to accelerate their effort to find alternatives to the U.S. model and the dollar as a reserve currency? I mean, we have taken sanctions for granted for so long that, of course, the U.S. is the biggest 800-pound gorilla in the world and sanctions will work. Well, I am not so sure that that is going to be forever true, and I am really concerned about the intransigence that we perpetrated on our financial balance sheet is putting that in jeopardy.

Would you both respond to that quickly?

Mr. ZARATE. Senator, you raise a really important and fundamental point. You are right, this is not 2005, and the Chinese have adapted to the Banco Delta Asia action. I think the Chinese have a dual strategy. One is to play in the existing economic and financial order and to become big players in that, and they are doing that. In that context, they have to play by international norms and rules, and in many ways, we are still the largest proponent of that. They are in theory cooperative partners in that. And in that realm, that is where we can affect them most. If they want to—

Senator PERDUE. Would you agree that that is changing over time? It has changed since 2005, as you just said. It is going to change over the next decade as well.

Mr. ZARATE. Absolutely. And it is not static, of course. And their leverage over us in many ways, their size, not just of their banks but of their economy, their ability to dictate new rules of the road, leads to the second strategy, which is your point: Can they begin to change the rules in a way that puts China at the center or at least allows them to dictate better what the rules are? You have seen this with intellectual property, with our technology companies. You have seen it certainly with alternate payment systems, UnionPay. They do not rely on Visa and MasterCard. They have got their own.

And so they are trying to develop a parallel structure, and you are right, there is a potential that anything we can do can accelerate that. But for now, they are still trying to play in the existing structure, and they want to be seen as legitimate players. And it is based on those principles and norms that they have subscribed to that I think we have the greatest strength. And that was the linchpin with BDA.

Senator PERDUE. Right.

Mr. ZARATE. The reason they could not object was they realized that what BDA was doing was anathema to international norms and principles, their own laws. And if we can continue to drive that kind of a theme and that kind of a strategy, I think we are likely to be more effective than not.

Senator PERDUE. Mr. Szubin.

Mr. SZUBIN. Senator, I think you raise a really important point, and it is obviously not a point just about North Korea on sanctions in this context, but the broader threat horizon and how sanctions are used over the coming decades.

For now, our leverage is still supreme, and China does not have an alternative, no country has an alternative to the international financial system as it is set up where the U.S. dollar is the primary currency and the U.S. banking system is the most pivotal, it is the fulcrum.

So I do not think our sanctions leverage has today, in 2017, diminished in a material way from where it would have been a decade ago. But I think our use of sanctions over the last decade has certainly prodded and prompted a change in thinking on the part of countries like China, non-aligned movement countries, about, wait a minute, how dependent can we afford to be on this Western framework? And the more we use secondary sanctions as a tool—and I do see a line between secondary sanctions and primary sanctions, and I can explain why if there is interest. But the more we use secondary sanctions as a tool, where we are in the most blunt way saying to countries around the world you do business with X, or you do business with us, period. It is not about conduct. It is not about hosting missile transactions or terrorist transactions. You are going to do business with a bank in that country, you are done. The more we are going to be seen as using our financial primacy as a weapon and cramming our foreign policy down the throats of other countries by force of that weapon.

So I think we need to be very, very careful in the use of that tool. That does not mean we do not ever use it. It just means we have to be deliberate.

Senator PERDUE. But the way we use it today is different than the way we have used it in the past because of all the things you both have said.

One last question. I am out of time. But the shadow banking system really concerns me. I think at the end of last year, the public banking system had about \$33 trillion directionally. I think that is correct. The shadow banking system estimates are as high as \$9 or \$10 trillion, so it is a significant part of their overall banking system that I do not think we can get to.

So the question is: Is North Korea playing in that shadow banking area today?

Mr. SZUBIN. North Korea, as I mentioned earlier, Senator, is going to use any opening it can find to move money.

Senator PERDUE. Are they in it today?

Mr. SZUBIN. Yes. I mean, depending on how you want to define shadow banking, absolutely. They are using cash couriers. They are using ancient ways of moving money that predate the banking system. But they are also using and, frankly, dependent on modern banks, and the reason I say that is they have got billions of dollars of import needs every year. In order to pay for that, you are not going to be able to have a cash courier or a shadow bank arrange for a payment to a reputable exporter. The reputable exporter wants to see a wire payment show up from a bank, and they are not going to be paid in North Korean currency. I can assure you

there is no exporter anywhere in the world who wants to be paid in North Korean currency.

So that is a vulnerability for North Korea. It means it has to be earning foreign currency, reputable currency, into reputable bank accounts, and that is a vulnerability that, as Juan was saying earlier, I think we have yet to fully exploit. That leverage is there, and so this myth that North Korea is somehow isolated, a pariah kingdom, and, therefore, sanctions-proof is not the case.

Senator PERDUE. Right. Thank you both.

Thank you.

Chairman SASSE. Thank you.

Could we go back and get a little bit of a level set on the North Korean economy more generally? Let us talk about GDP and about essentially imports and exports. And I understand, I think, some of your testimony said that about 90 percent of their trade is with China. But help us understand all the ways that they are using an international banking system for so that we can sort of tailor down our understanding of how targeted these secondary sanctions against Chinese financial institutions might be. And both of you having a discussion and to the degree you differ on anything, that would help flesh out stuff for us as well. So I will throw it to both of you.

Mr. SZUBIN. Of course, Senator. So the estimates here are pretty rough, and I think the best economists who are looking at this issue acknowledge that the estimates are going to vary pretty wildly. This is not, you know, a country like Mongolia or Belgium where you might have regular IMF visits, who are doing metrics, and as I said earlier, North Korea's banking system and import-export system sometimes looks more like that you would see of a criminal organization than that of a country.

But with all of those caveats, the estimates I have seen are between \$3 and \$5 to \$6 billion a year in imports and something around that level in terms of their exports. That is pretty significant. The major imports are petroleum, coking coal, and textiles. Their major exports are minerals, with coal being No. 1, but a number of other minerals both more high value, like rare earth type, and then more basic minerals being right behind it. And North Korea, of course, is also selling its weapons to a number of countries around the world, and that is dangerous both as a source of revenue but, of course, the missile technology that they are peddling itself.

For all of these sales, and anytime you are getting above the tens of millions of dollars, you need access to the banking system. So that is that reliance that we have been talking about, and that presents a vulnerability.

When you talk about China, I have seen estimates of more than 50 percent, estimates of 75, estimates as high as 90 percent in terms of how much trade. Certainly when you look at their largest source of export revenue, coal sales, the portion that is derived from China is over 75 percent. And China we have seen suspend those purchases temporarily, sometimes for a few months, sometimes for a few weeks, or just bring those imports down. But that leverage is in China's hands, and China is aware of that. I do not think that is a point that is lost on China.

So the truth is not that North Korea is sanctions-proof but, in fact, that North Korea has, to its own detriment, put all of its eggs in one basket or many of its eggs in one basket, and that is China, which makes it very much vulnerable to sanctions pressure.

All of this comes back, though, to the key question we have been discussing earlier, which is: How do you get China to exert that pressure in a far more meaningful way than they have to date? And they have played with the dial. They have turned it up. They worked with us on not only drafting but sponsoring U.N. Security Council resolutions to sanction North Korea. So they have not been immovable on this, but they also have not come anywhere close to the level of pressure that it is going to take.

And to my mind—and I am not a foreign policy expert, but to my mind, the central hesitation on their point is stability. They like the status quo, as bad as it is, as unpleasant as it is, more than they are willing to deal with these very ugly scenarios of regime collapse. And that is a conversation that we need to have with China. What is our end game here? What is our, the U.S. Government's, end game? Yes, we know we want to put pressure on North Korea to bring Kim Jong-un to the table. But let us say we turn the heat up very, very high and he refuses to come to the table. Let us say he is committed to this to his death. What does the pressure campaign look like then? And how are we ensuring that we are not looking at a total regime collapse? If we are looking at leadership change, which is different from regime collapse, how are we navigating those waters? And how are we going to work with China to ensure that their nightmare scenario is not realized?

I think we have overlapping interests here, or at least reconcilable interests. I think there is room for that conversation to be fruitful. But that is going to be a sine qua non of any successful campaign involving real China cooperation on turning these screws up.

Chairman SASSE. Very helpful.

Mr. Zarate.

Mr. ZARATE. Mr. Chairman, I think one way of thinking about the North Korean economy is in three buckets. One is their sort of what would be called "normal trade" with China; that is to say, trade in coal, largely, but as Adam said, more and more with other minerals being extracted. I gave the estimate in the testimony based on one expert that 90 percent of trade with North Korea is China-dependent. As Adam says, that is an approximation, and I do not think we have an exact number. But there is a form of formal elements of the economy that are functioning. In fact, if you look at the first quarter numbers for this year, it appears that you have an increase in trade with China, according to some of the experts, by over 35 percent. And so that trade is real. It uses agents and companies and financial institutions to actually do the trade, as you would imagine normal trade. And so there is kind of an ecosystem around that.

There is the ecosystem around the illicit financing and the sanctions evasion and the smuggling, which we all know about. As Adam said, North Korea is known as the "Mafia State," you know, the "Sopranos State," and very much acts in that way. And so they change front companies, they change agents, they change ship reg-



istries. The recent U.N. Panel of Experts report indicates that they are growing more sophisticated in terms of how they are engaging in these network operations and moving money, materiel, and arms around the world, to include in Africa now. And so there is an entire illicit economy that feeds the regime and gives it sustenance.

And then there is a third element that is important, especially from a human rights perspective, which is their use of slave labor or forced labor, both within the country and then outside of the country. And most people who do not concentrate on North Korea would not realize that there are estimates of maybe over 50,000 forced laborers working around the world, being paid but where the pay is actually going straight back to the North Korean regime. Some of the estimates is that this goes up to \$2 billion per annum, per year, worth of income. These are laborers of all sorts in places that you would not anticipate, places like China, of course, but also Qatar, Poland, other places where these are forced laborers, and their pay is going right to the regime.

And so there are these ecosystems of an economy in which the North Korean regime uses all elements of the financial system, to Adam's point, formal and informal, as a way of moving money in and out of the country as needed and largely trying to pull capital in so that the regime can strengthen itself, strengthen its own economy, and ensconce the regime.

A final point that is important and interesting is recent articles about sort of the flourishing of more of a private sector in North Korea. There is a bit more of what we could call a private sector economy in North Korea. That is interesting to watch because I think a lot of that is being amplified and affected by some of this cross-border trade with China. And so China maybe could impact some of those developments as well if they understand how that is evolving. But as Adam indicated, it is a difficult question as to how you think about Chinese touch points in each of those ecosystems. But that is one way of thinking about it.

Chairman SASSE. Thank you. Very helpful. In a subsequent round, I want to come back to this. It was in your testimony as well as the slave and forced labor. But one more thing before we go to Senator Donnelly. You said maybe we have not had a level set at any point in this hearing on the extant primary sanctions regime that exist. And so when you distinguish among the three buckets of trade that they have, first of all, the \$3 to \$6 billion estimate—and I know that we do not really have great numbers on this, but what share of GDP would we think their import–export number is? How large is the total North Korean economy?

Mr. SZUBIN. I am not sure. I believe the estimates are \$20 to \$30 billion.

Chairman SASSE. OK, so a significant share of their economy is import–export. And given the current sanctions regime—and I understand all the caveats that both of you have given, and I think you have tried to be delicate, and I think we are not trying to beat anybody up here that a new Administration does not have clarity of a long-term strategy vis-a-vis North Korea and that you could try to bring the Chinese along at this stage, but it is perplexing to think that the Chinese are worried about these same set of problems, and yet your point about the four large banks and the way

that you would insulate them from potential exposure to a sanctions regime by allowing the smaller banks to do this and that not necessarily being something that we could target in a way that could affect larger decision making, is any of the extant trade that is cross-border something that is potentially violative of the primary sanctions regime? So besides the financial institutions question that are the subject of this hearing, at the level of primary sanctions, is there already cross-border Chinese–North Korean trade issues that should also be on our docket for discussion here?

Mr. SZUBIN. Yes, absolutely. And that is what I was alluding to, perhaps too indirectly, in my testimony, talking about existing authorities providing a lot of leverage right now. And it is not just U.S. sanctions, U.S. primary sanctions. Interestingly, the U.N. Security Council resolutions provide a lot of leverage. If those were being implemented as they are written, you would see massive impacts, massive pressure on North Korea.

So, you know, sometimes it is not a question of what new tool do we need, but how do we use the existing tools which are binding on countries? And China is not just a member State of the U.N. They are a co-drafter of these resolutions. How do we get better implementation? And the resolutions target each one of North Korea's major sources of export revenue, which you have been asking about today. They target their coal sales. They target forced labor, as Juan was talking about. They target banking access. And, of course, as with any resolution, there is room to interpret it more expansively and room to interpret it more narrowly. So when a U.N. Security Council resolution says there is a prohibition on offering correspondent banking services to North Korea, you could interpret that in a very narrow way and say, well, North Korea does not use correspondent banking, and so there is nothing here. Or you could interpret it in a robust and meaningful way and say, What are the de facto access points that North Korea is using as its correspondent banking beachheads in China, and how do we cut them off? And there is a lot of room to enlist China's help, forgetting about any U.S. sanctions, just under the U.N. Security Council umbrella.

Mr. ZARATE. It is a really important point that Adam just made. The interpretation of existing sanctions is really a critical question, and the Chinese have traditionally viewed these Chapter 7 obligations in the context of the U.N. sanctions in a very limited way.

The other good example is in the shipping context where suspect cargo and shipping moving in and out of North Korea, especially that tied to weapons of mass destruction programs, are subject to interdiction. The Chinese read that very narrowly. What is suspicion? How do you define it? How do you evidence it? That is an area where a more robust interpretation, as I was indicating to Senator Donnelly, in terms of shipping interdiction could be incredibly powerful and based on international existing sanctions that the Chinese have agreed to.

There is also the role—and we have seen this with some of the revealed networks that have touch points with China. There is also a role for greater just investigation and analysis around what these corporate structures and networks look like. There is a lot of work

being done in the private sector. Sayari Analytics has been cited in the press. C4ADS has put out important reports.

Just looking at ownership and control interests, that alone has been very revelatory, and that is based on existing sanctions. And as Adam indicated, the last Executive order signed—he probably fashioned it himself when he was at the Treasury—in 2016 was sort of a potpourri of delicts that North Korea was being targeted for: human rights, cyber, other activities. And so we do have authority. The question is: How amply and aggressively do we apply it? And can we draw that to the international obligations and then, frankly, compel the Chinese to come along with us?

Chairman SASSE. Yes, thank you, and how we rank order those, back to Senator Donnelly's great opening questions about if you were doing two or three things, how would you rank order the narrow or broader interpretations of extant primary sanctions and this new secondary sanctions bucket we are considering today.

Senator Donnelly.

Senator DONNELLY. Thank you, Mr. Chairman.

One of the things you hear about North Korea is that they would rather have their people eat grass than give up any part of their nuclear program, any part of their weapons program. So when you look at this, how do you change their calculus? If China cooperates more with us, that they look and they go—is there a push point for North Korea where they say, you know, now we probably have to come to the table a little bit more? Or do they look and go we just do not care? And basically the only way you stop them is having them run out of resources. Mr. Szubin.

Mr. SZUBIN. You know, to an intelligence analyst, I think that is often the \$64,000 question, the leadership decision-making calculus. And I personally suspect that Kim Jong-un may be immovable on this, by which I mean, yes, he would rather see his people eat grass, starve, see widespread famine before he relinquishes his nuclear weapons. And it is not entirely irrational if you put yourself in his shoes. He believes that they are the guarantor of his survival, and that if he gives up the program, he will be done away with.

The truth, though, is because of the vulnerabilities, the reliance that he has on international export earnings—and one of the best examples of this is the patronage system—that keeps him in power. His ability to buy off other North Korean elites in the military and the intelligence services, just the sort of aristocrats or oligarchs, as you will, of North Korea, he needs access to foreign export earnings for that and foreign luxury goods for that.

But what if that dries up? How dedicated are those people to their beloved leader? I do not think very. And so he faces a real vulnerability, a real risk of losing his control over the leadership. That may be what is required before a North Korean Government comes to the table.

But I do believe that a North Korean Government, not necessarily this North Korean leader but a North Korean Government, a person who might succeed him, would see the tradeoff as not only necessary but compelling, the tradeoff being your question: giving up their nuclear weapons, coming into compliance with international resolutions when it comes to their nuclear program, in ex-

change for allowing them some form of access to international trade and international currency and, therefore, survival.

Senator DONNELLY. Mr. Zarate.

Mr. ZARATE. Senator, you ask the fundamental question with respect to what is the strategic purpose of a financial pressure campaign, and I think there are several answers here that do test the proposition that this can be an effective tool to change Pyongyang's decision making. And I think ultimately this is a regime, as Adam said, that is focused on its own survival; it is focused on the development of a nuclear and missile program that ensconces its internal power as well as its deterrent capability externally; and it is not going to give that up unless there is a sense of existential threat to the regime itself.

But I think sanctions, and effective sanctions, and a financial pressure campaign can do several things. There is a material dimension. You can make it harder for them to actually acquire the things that they need to advance in their programs. Very hard to do, but if done effectively, you can at least slow the progress and clock. And we have seen that with other sanctions programs.

Second is you can affect the decision making. These leaders have budgets to deal with. If they have less income coming in because the sanctions are proving more effective, they are going to have to make a decision, whether it is feeding their people or developing the next version of the nuclear program. And so forcing them to actually make these hard decisions and to stress them internally is part of the goal.

Affecting their sense of regime stability, to Adam's point, the patronage system regime stability, it is part of the reason one of the recommendations I have is we should announce that we are going to engage in a leadership asset hunt from the get-go. It may not be that there is much we can actually find, but just signaling that we are willing to do that, to use the elements of the international system that we have built over time, that we usually reserve for when a bad regime collapses or when there is a failed State or something, let us use that *ex ante*, let us use it before the fact to say we are going to try to find where the leadership is stealing assets from its people, we are going to try to capture it and preserve it as a way of dealing psychologically with this issue, and perhaps even affecting the Chinese, and then having the Chinese actually change their behavior. That could have an impact in Pyongyang. The Chinese are the lifeline, the backstop for North Korea, diplomatically, economically. If that begins to change in more dramatic, fundamental ways, that could impact what happens in Pyongyang. We just do not know. And I think Adam's caution about being careful about where we go is right. I also think we have to explore what we can potentially do, because if we continue to wait, I think we know where we are going to end up. We are going to end up with a North Korean regime that has a nuclear capability, has potentially intercontinental ballistic missiles, has multiple missile platforms by which they can potentially threaten and attack U.S. interests, not just in Guam and Hawaii but in San Francisco and New York. And that is an unacceptable position to be in.

And so I think we have got to be a little bit of risk takers here and a bit more aggressive than we have been in the past in terms of what we try to do influence their decision making.

Senator DONNELLY. Thank you.

Chairman SASSE. Could we go back to this question of slave or forced labor, both inside and outside the regime? Tell us a little bit more on how it works inside the regime for sure, but also abroad, how do they have certainty that they will get these assets back? What is the command-and-control structure of those remittances?

Mr. ZARATE. Mr. Chairman, the internal dynamics I do not pretend to know well. The reality is the North Korean regime uses different types of forced labor internally—prison labor, forced labor, for generating billions of dollars of product, commerce, revenue internally to the North Korean economy. I do not have details as to how they actually run that from a security perspective, but it is not a pleasant regime in that regard, and certainly it is a command economy in all the senses that that means.

I have a bit more familiarity with what is happening on the outside, which is that the North Koreans have purposefully in essence sold their labor into foreign markets cheaply to serve across the board in terms of a variety of labor and service sectors, everything from working in shipyards to construction to even a little bit higher-end kind of labor in pockets around the world. Part of that is to not only sort of gain revenue, but also gives them some influence and allows them to operate in countries around the world where they otherwise would not have a presence.

And so there has been recent news reports, for example, of the North Korean workers' presence in Poland, workers that are working in the shipyards. Vice News did a big report on this. And, in essence, what is done is these are forced laborers; they work in what are considered to be inhumane conditions. They are paid for their labor. That pay does not go straight to them, straight to their bank account, straight to their family members. It is not part of some remittance scheme where they send it back to their wife or grandmother or whomever. The payment actually goes back into a North Korean account, back into North Korea. And in some cases, based on what I have read, there are additional commissions paid for purposes of payment to the Government. So it is not just the pay for the labor. It is a commission for the State itself that then goes back into the coffers.

Mr. Chairman, in fairness, I do not pretend to know how some of that is financed, but I imagine, as Adam indicated, there are elements of the financial system that are used as a way to facilitate the movement of the money back into North Korea. And, again, as I indicated earlier, this is to the tune of \$1 billion, some estimates over \$2 billion worth of revenue, and it is why I think we should have a concerted effort—we have had sanctions on the books to date on this, but a concerted effort to tie the forced labor and human rights abuses to their financing as a way of understanding what the financial networks are and as a way of adding to the international taint of doing any business with the North Koreans. It is almost unimaginable that you would have this scheme operating in legitimate countries around the world. There should be an end to it. The labor should not be exploited, obviously. And cer-

tainly there should not be payments and commissions being paid back to the North Korean regime. That is an area of focus that I think not just people like us who care about sanctions would focus on. This is something the human rights community around the world should be heavily focused on as well.

Chairman SASSE. Mr. Szubin.

Mr. SZUBIN. The only thing I would add is my understanding is they typically are sending one member of a family only in situations where family members stay behind so that there is leverage to ensure that that person does not defect or run away, and it is that leverage that incents the enforcement mechanism to keep the forced labor in place and to keep them earning.

I think that the more knowledgeable, sophisticated human rights people who have looked into this have come away with the conclusion that it is, as Juan says, an appalling practice. It is not a situation where you can really argue both sides, that this is a financial lifeline for these families. Far from it.

The other thing I would note is North Korea does not need to repatriate these funds. It actually needs money located in third countries for its imports. And so oftentimes it can just accumulate money, whether in the Gulf, whether in Eastern Europe, whether in China, whether in Southeast Asia, and then use that to finance its imports. But as Juan says, those are funds, those are accounts, those are front companies that we and our allies should be targeting.

Chairman SASSE. Really helpful. We are under constraints because of some Senate objections on the floor that we have to conclude the hearing at this time. But I think there are a number of us on this Committee who would like to return to you and ask those targeted questions about what you would rank order, if Secretaries Mnuchin and Tillerson came together and asked your counsel, and how nuanced the new Under Secretary's team will be as they are getting stood up. I think there are a number of people in both the Article I and Article II branches that are grateful for your past work, but would also benefit from your present and future counsel.

So thank you both for being here today. This hearing is concluded.

Mr. SZUBIN. Thank you, Chairman.

Mr. ZARATE. Thank you, Mr. Chairman.

[Whereupon, at 11:27 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

**PREPARED STATEMENT OF ADAM J. SZUBIN**

DISTINGUISHED PRACTITIONER-IN-RESIDENCE, JOHNS HOPKINS UNIVERSITY, SCHOOL OF ADVANCED INTERNATIONAL STUDIES; OF COUNSEL, SULLIVAN & CROMWELL; AND FORMER ACTING SECRETARY OF THE TREASURY AND ACTING UNDER SECRETARY OF THE TREASURY FOR TERRORISM AND FINANCIAL CRIMES

MAY 10, 2017

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 bipartisan 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 6 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 JPMorgan 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 unsheath 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-a-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 percent. 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-a-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.

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#### PREPARED STATEMENT OF JUAN C. ZARATE

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MAY 10, 2017

Chairman Sasse, Ranking Member Donnelly, and distinguished Members of the Senate Banking, Housing, and Urban Affairs Subcommittee on National Security and International Trade and Finance, I am honored to be with you today to discuss the urgent need to pressure North Korea and the utility of secondary sanctions against Chinese institutions in such a strategy.

This is a timely and important hearing. The international security challenge from North Korea has grown more dangerous and direct for the United States. The regime in Pyongyang remains intent on developing ballistic missile and nuclear capabilities that will allow it to reach and threaten the United States directly. In defiance of international sanctions and pressure, North Korea has quickened the pace of missile and nuclear tests, demonstrating ever-expanding capabilities and claiming to have the ability to place a nuclear warhead on the tip of an intercontinental ballistic missile. Despite recent missile launch failures, the regime continues its march toward these capabilities.

What was once seen solely as a threat to peace and stability on the Korean Peninsula and our regional allies has now become a looming, direct threat to the U.S. homeland.

All the while, North Korea proliferates its technology for profit, engages in illicit financial and commercial activity, exploits forced labor to make money for the re-

gime, and has deployed cyber tools to attack adversaries and the private sector, including U.S. companies and the banking system. North Korea remains a threat to international security and to the integrity and stability of the financial system.

The threats from North Korea require a sober, more comprehensive, and urgent response, including the use of financial and economic tools and pressure. This in turn requires a more aggressive and imaginative approach leveraging new tools and mechanisms, including secondary sanctions against Chinese and other businesses, entities, and networks still doing business with North Korea.

China is North Korea's economic and diplomatic lifeline, and its principal interest is ensuring the stability of the North Korean Government and avoiding regime collapse. As a result, China has maintained ties with North Korea and been unwilling to bring overbearing pressure on its ally in Pyongyang. Over the years, North Korea has found outlets and connectivity to the financial and commercial system through Chinese banks, companies, and agents—to circumvent sanctions, serve their economy, and enrich the regime.

Because China remains the regime's backstop, the United States needs Chinese cooperation and support to slow and stop North Korea's missile and nuclear programs. The Chinese calculus has not changed in the past and will not change unless its own interests are fundamentally threatened or affected. Chinese and American interests do not yet align with respect to North Korea.

This is a moment for China to assume its role as a great power and to influence its North Korean ally to stop its nuclear and missile programs and contain the threats from proliferation. This Administration and Congress will need to grapple with how best to obtain, coerce, and sustain Chinese cooperation in order to maximize pressure on North Korea. Ultimately, the United States must find a way to change Pyongyang's calculus and the trajectory of their nuclear program. This testimony addresses how to leverage financial and economic pressure, including secondary sanctions, to increase the chances of changing the calculus in North Korea and China and avoiding conflict.

My testimony has benefited directly from the ongoing work and contributions of Anthony Ruggiero at the Foundation for Defense of Democracies, along with the scholarship of Victor Cha and Bonnie Glaser at the Center for Strategic and International Studies, John Park at the Harvard Kennedy School of Government, and the Council on Foreign Relations' Task Force on North Korea led by Chairman Mike Mullen and Senator Sam Nunn, on which I served.

### **Core Principles for a Financial and Economic Pressure Campaign**

There are fundamental principles that should drive any serious financial or economic pressure campaign. These principles should inform the design, choreography, and strategy deployed before launching any type of sanction or form of economic coercion.

*Strategy Matters.* To be effective, an attempt to use sanctions or financial measures of any sort must nest within a coherent strategy and cannot stand alone. Too often, sanctions have been seen as either the only retreat for action to address a thorny national security issue or as a silver bullet that can bend behavior and alter a threat landscape on its own. For any financial pressure campaign to work, it must be in service of an understood strategy and complemented by other tools of statecraft, power, and coercion. In this case, the strategic objective must be to slow, stop, and ultimately reverse the North Korean nuclear program and ensure that the regime never has the ability to threaten U.S. territory with nuclear weapons. The financial strategy must then follow and be crafted to achieve this core goal, in aid of diplomacy, coercion, and material disruption of the targeted programs.

*Coercive Tools in Concert.* The sanctions and economic toolkit must be seen as part of a broader set of coercive tools that are more effective when deployed in concert to shape the environment. Interdiction of suspect North Korean shipping, arrests of those involved in North Korean illicit financial activity, broad-based information campaigns to weaken the regime's control of the information environment, and an aggressive focus on the regime's human rights abuses are all complementary and functional parts of any campaign to isolate the North Korean economy. These are also tools that should target, impact, and deter those who do business or finance the regime's activities. Sanctions must be seen as part of a broader effort to disrupt the regime's ability to resource its nuclear and missile ambitions and access the key elements of the financial and commercial system.

*Constant, Consistent Pressure.* For a financial pressure campaign to work, it must be applied constantly to identify and isolate North Korea's rogue behavior. U.S. and international sanctions and pressure in the past have suffered from applying an escalatory model based on reactions to North Korea's provocations, tests, and violations of existing sanctions. Such sanctions have been perceived as important simply

in aid of diplomacy. Although that is a critical use of these tools, in order to be effective, they must be seen as their own form of pressure, coercion, and disruption that complements our diplomacy. As a result, the sanctions approaches of the past have been dictated more by what the regime in Pyongyang does as opposed to what an effective financial and economic pressure campaign looks like. Any use of sanctions must be part of a broader campaign to sensitize the international community and markets to exclude rogue actors involved with North Korea from the legitimate financial and commercial system. Like weeding a garden, such work has to be consistent and constant, to shape market and Governments' behavior.

*Conduct-Based Focus.* A successful campaign against North Korea that enlists China and our allies would focus intently on conduct-based sanctions and measures that target the illicit, dangerous, and suspicious activities that violate international norms and principles and put the financial system at risk. A fundamental vulnerability for North Korea is that it is not only developing nuclear weapons capabilities in violation of international sanctions, but it is a criminal State. It is engaged in proliferation, massive human rights abuses, money laundering, corruption, sanctions evasion, counterfeiting, smuggling, drug trafficking, and other nefarious and suspect activities.

These activities are interwoven in how North Korea does business and should be isolated by the international community—Governments and the private sector alike—regardless of the state of diplomacy. Such activities are the subject of sanctions, criminal laws, and financial regulations. At a time of heightened concern over transparency and accountability in the financial system, there should be no objection to doing so, especially in major economies like China, Japan, and South Korea. As long as the efforts to target North Korean networks and their financial and commercial infrastructure remain focused on the activities that violate accepted international norms and principles, they will prove more effective and be amplified by the actions of the private sector and actors concerned about real and reputational risk.

*Altering the Chinese Calculus.* China must play a central role in pressuring North Korea, but its interests do not align with those of the United States and it has not been willing to exert existential pressure against the regime to force it to stop its nuclear program. For the United States, for too long, trying to coerce China to exert more pressure on North Korea has appeared as the third-rail of the sanctions debate. But we have reached a moment where we need to align U.S. and Chinese interests with respect to pressuring North Korea. We cannot ignore the role that Chinese actors are playing to evade sanctions, enrich the leadership, and enable the regime to develop its dangerous capabilities across the board.

If this is an urgent international security issue, the Chinese dimension cannot be spared attention, and the Chinese calculus must be altered. Chinese interests and standing will have to be put at risk directly and indirectly. Of course, this needs to be a balanced approach, understanding direct financial and economic confrontation with China through sanctions will likely prove counterproductive. This balance can be drawn if China sees itself as a partner in these efforts and if the campaign is geared toward targeting and isolating rogue financial and commercial activity and those flouting legitimate authorities and international norms. Getting the Chinese to realize that the continued, current path with North Korea is itself creating regime and regional instability—and putting its own reputation and economy at risk—will be a difficult but essential element of any campaign.

U.S. sanctions against North Korea have lacked both a comprehensive approach of this nature and a willingness to put China's interests on the table. The U.S. Government's recent strategy of strategic patience and a prior pattern of lessening financial pressure or rewarding the regime in Pyongyang in the face of provocation have not forced the Chinese to make hard choices. The idea of pressuring China to alter its calculus is difficult, but if the problem of a nuclear armed and threatening North Korea is growing acute, then we need to apply a more aggressive approach.

It is in this context that the question of whether and how to use secondary sanctions and other types of financial tools and measures arises. Before treating the issue of secondary sanctions, it is important to understand the nature of North Korean financial activity and its dependence on the Chinese economic and financial system.

### **North Korean Financial Activity and Chinese Connectivity**

For years, the North Korean regime has found creative and often devious ways to run its economy. They have raised and moved capital into the Hermit Kingdom in order to prop up the regime and develop an expensive nuclear and missile program. It has adapted to sanctions and attempts to isolate the regime financially and commercially—relying on the Chinese economy, including Chinese banks, networks,

and brokers, for most of its trade and connectivity to the commercial and financial world. The North Korean regime has consistently leveraged commercial relationships to its advantage and worked around existing sanctions and restrictions. Much of this has involved illicit financial activity and schemes to raise money for the Government.

The North Korean schemes outside their borders rely heavily on front companies, layered transactions, opaque ownership structures, and trusted or corrupt relationships, making it difficult for legitimate banks and compliance systems to detect and stop its nefarious activities. The United Nations has issued annual reports that detail North Korea's aggressive efforts to evade financial sanctions.<sup>1</sup> In 2011, the Financial Action Task Force called for its members to impose countermeasures on the Kim regime due to its significant lack of anti-money laundering and counter-terrorism finance controls.<sup>2</sup> Last year, the United States Treasury labeled North Korea a jurisdiction of "primary money laundering concern," ordering that the country be cut off from the U.S. financial system and prohibiting foreign banks from providing indirect access.<sup>3</sup> In the designation, the Treasury Department described North Korea's financial activities as a "threat to the integrity of the U.S. financial system."<sup>4</sup>

The U.N. Panel of Experts has investigated Pyongyang's financial activities, noting that "circumvention techniques and inadequate compliance by Member States are combining to significantly negate the impact of the resolutions."<sup>5</sup> The Panel reported that North Korea generates "significant revenue" from its financial networks with most denominated in U.S. dollars, euros, and renminbi.<sup>6</sup>

The regime generates profits from all forms of illicit activity—from counterfeit cigarette smuggling to proliferation. The U.N. Panel of Experts noted that North Korean proliferation networks are expanding and blending to include arms trafficking in Africa and the manufacture and trade of military technologies. Such networks rely on trusted and sophisticated agents able to move people, goods, and money undetected across borders. Those networks and agents are growing more sophisticated in masking and layering corporate identities and records and play within the seams of the international system.

The North Koreans are profiting from their human rights abuses. Within the country, unpaid labor earns around \$975 million for the Government each year, according to Seoul-based NGO Open North Korea.<sup>7</sup> The report estimates that 400,000 people make up the lowest class of forced laborers, or *dolgyeokdae*, who are put to work on construction projects throughout the country.

The regime also profits handsomely from forced labor outside its borders. U.N. Special Rapporteur on Human Rights in North Korea Marzuki Darusman estimated that there are approximately 50,000 North Koreans abroad, earning between \$1.2 billion to \$2.3 billion per year for the DPRK.<sup>8</sup> Countries like China, Poland, Qatar, and others allow their companies to use such labor and to make arrangements to pay North Korea.<sup>9</sup>

<sup>1</sup>United Nations Security Council, "Reports of the Panel of Experts Established Pursuant to Resolution 1874 (2009)". ([https://www.un.org/sc/suborg/en/sanctions/1718/panel\\_experts/reports](https://www.un.org/sc/suborg/en/sanctions/1718/panel_experts/reports))

<sup>2</sup>Financial Action Task Force, "Public Statement—24 February 2017", February 24, 2017. (<http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-february-2017.html>)

<sup>3</sup>U.S. Department of the Treasury, Financial Crimes Enforcement Network, "Finding That the Democratic People's Republic of Korea Is a Jurisdiction of Primary Money Laundering Concern", 81 *FR* 35441, June 2, 2016. ([https://www.fincen.gov/sites/default/files/shared/2016-13038\(DPRK\\_Finding\).pdf](https://www.fincen.gov/sites/default/files/shared/2016-13038(DPRK_Finding).pdf))

<sup>4</sup>U.S. Department of the Treasury, Financial Crimes Enforcement Network, "Finding That the Democratic People's Republic of Korea Is a Jurisdiction of Primary Money Laundering Concern", 81 *FR* 35441, June 2, 2016. ([https://www.fincen.gov/sites/default/files/shared/2016-13038\(DPRK\\_Finding\).pdf](https://www.fincen.gov/sites/default/files/shared/2016-13038(DPRK_Finding).pdf))

<sup>5</sup>United Nations Security Council, "Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)", S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>6</sup>Ibid.

<sup>7</sup>Steven Borowiec, "North Koreans Perform \$975 Million Worth of Forced Labor Each Year", *Los Angeles Times*, October 6, 2016. (<http://www.latimes.com/world/asia/la-fg-north-korea-forced-labor-20161006-snap-story.html>)

<sup>8</sup>Christian Vonscheidt and Miriam Wells, "Cash for Kim: How North Koreans Are Working Themselves to Death in Europe", *VICE News*, May 23, 2016 (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>); Edith M. Lederer, "U.N. Investigator: North Koreans Doing Forced Labor Abroad To Earn Foreign Currency for Country", *AP*, October 28, 2015. (<https://www.usnews.com/news/world/articles/2015/10/28/un-investigator-north-koreans-doing-forced-labor-abroad>)

<sup>9</sup>VICE News discovered that 14 Polish companies have used North Korean workers between 2010 and 2016. The workers were supplied to Polish companies Armex and Alxon by the Korea Rungrado General Trading Corporation. Working conditions in these shipyards meet the defini-

The workers are used in industries like shipyards, surface construction, furniture production, agriculture, metalworking, medicine, and finance. Wages are paid in foreign currency directly to the DPRK as a method of bypassing U.N. sanctions.<sup>10</sup> Workers are paid between \$120 and \$150 per month, but the employers “pay significantly higher amounts” directly to the North Korean Government.<sup>11</sup>

With all this, China remains North Korea’s most important economic and trading partner. China accounts for approximately 90 percent of North Korea’s total trade volume, and Chinese–North Korean trade was up 37.4 percent in the 1st Q of 2017 when compared to 2016.<sup>12</sup> China has benefited from access to North Korean coal and minerals while North Korea has used Chinese networks and its economic system, in particular broker relationships and access to financial institutions, as a way of accessing hard capital and driving its economy.

Unfortunately, China has allowed its economy to be used by North Korea to evade sanctions and engage in illicit activity. In most cases when a new North Korean sanctions evasion network is revealed, inevitably it has a nexus to or in China. Given Beijing’s robust security services and sensitivities to exposure to North Korean activity, it is hard to believe the Chinese leadership is not aware of such exposure to North Korea and the Kim regime’s activities.

Recent examples of how North Korea’s financial and commercial activities are intertwined with the Chinese economy and financial system are illustrative:

- *Limac–Ryonbong Joint Venture*: This past weekend, the *Wall Street Journal* reported that Limac Corp, a Chinese State-owned company, has maintained a joint venture since 2008, with a North Korea’s Ryonbong General Corp, which has been under U.S. sanctions since 2005, for its involvement with weapons of mass destruction.<sup>13</sup> The North Korean firm has reportedly “tried to procure chemicals for solid-fuel for rockets” in the past, and several of its employees were sanctioned as recently as 6 weeks ago by the Treasury Department.<sup>14</sup> Meanwhile, the Chinese firm maintains a U.S. affiliate, and records show that in 2013, it shipped Canadian nuclear-power equipment to China via the U.S.<sup>15</sup> This represents just one node of the China–North Korea nexus. Sayari Analytics (which discovered the link) “says it has identified more than 600 Chinese companies that trade with North Korea.”<sup>16</sup>
- *The Dandong Hongxiang Network*: Dandong Hongxiang Industrial Development Co., Ltd and four Chinese individuals created a mechanism to help North Korea evade financial sanctions.<sup>17</sup> The network was exposed in August 2016, in a

tion for forced labor, as laid out in the European Convention on Human Rights and the International Labor Organization. (Christian Vonscheidt and Miriam Wells, “Cash for Kim: How North Koreans Are Working Themselves to Death in Europe”, *VICE News*, May 23, 2016. (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>))

<sup>10</sup> Christian Vonscheidt and Miriam Wells, “Cash for Kim: How North Koreans Are Working Themselves to Death in Europe”, *VICE News*, May 23, 2016. (<https://news.vice.com/article/cash-for-kim-how-north-koreans-are-working-themselves-to-death-in-europe>)

<sup>11</sup> Jethro Mullen, “North Korea Believed To Earn a Fortune From Forced Labor Overseas, U.N. Says”, *CNN*, October 29, 2015 (<http://www.cnn.com/2015/10/29/asia/north-korea-un-forced-labor-overseas/>); Edith M. Lederer, “U.N. Investigator: North Koreans Doing Forced Labor Abroad To Earn Foreign Currency for Country”, *AP*, October 28, 2015. (<https://www.usnews.com/news/world/articles/2015/10/28/un-investigator-north-koreans-doing-forced-labor-abroad>). The Leiden Asia Center estimates that between 70–100 percent of the earnings go directly to the DPRK.

<sup>12</sup> Eleanor Albert, “The China–North Korea Relationship”, Council on Foreign Relations, April 26, 2017. (<http://www.cfr.org/china/chinanorth-korea-relationship/p11097>)

<sup>13</sup> Jeremy Page and Jay Solomon, “Chinese–North Korean Venture Shows How Much Sanctions Can Miss”, *Wall Street Journal*, May 7, 2017. (<https://www.wsj.com/articles/chinese-north-korean-venture-shows-how-much-sanctions-can-miss-1494191212>)

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*

<sup>16</sup> Jeremy Page and Jay Solomon, “Chinese–North Korean Venture Shows How Much Sanctions Can Miss”, *Wall Street Journal*, May 7, 2017. (<https://www.wsj.com/articles/chinese-north-korean-venture-shows-how-much-sanctions-can-miss-1494191212>)

<sup>17</sup> The four individuals are: Ma Xiaohong, a Chinese national who resides in Dandong, China, and was the majority owner (80 percent) of DHID; Zhou Jianshu, a Chinese national who also resides in Dandong and was the general manager of DHID working directly for Ma; Luo Chuanxu, a Chinese national who is the financial manager of DHID and an assistant to Ma and Zhou; and Hong Jinhua is a Chinese national who also resides in Dandong and was the deputy general manager of DHID working for Ma. U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged with Using Front Companies To Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Pro-

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ground-breaking study, *In China's Shadow*, published by the Center for Advanced Defense Studies (C4ADS) and the Asan Institute for Policy Studies.<sup>18</sup> The Justice Department filed an indictment against the company and four individuals shortly after the publication of the C4ADS–Asan study.<sup>19</sup> From 2009 to 2015, the network allegedly routed at least \$75 million through the U.S. financial system, and from June to August 2016, the network routed \$8 million through the U.S. financial system. The Treasury Department also designated the four Chinese nationals and Chinese companies in September 2016, in coordination with the public unsealing of the indictment.<sup>20</sup>

- *Global Communications Co (Glocom)*: Pan Systems Pyongyang, a North Korean branch of a Singapore-based company, created Glocom claiming it was a Malaysia-based company to sell prohibited military equipment. The U.N. Panel of Experts reported that the company used bank accounts in China to transfer funds to suppliers located in mainland China and Hong Kong.<sup>21</sup> The Panel noted that a “series of transactions by Glocom initiated by companies registered in Hong Kong, China, and cleared through several United States correspondent banks in New York.”<sup>22</sup> The U.N. noted that Pan Systems Pyongyang is controlled by the U.S.-designated Reconnaissance General Bureau (RGB), North Korea’s intelligence agency, and also received funds from U.S. and U.N.-designated Korea Mining Development Trading Corporation, a key proliferation entity.<sup>23</sup>
- *March 31, 2017 U.S. Designations*: The Trump administration’s actions against North Korea’s financial facilitators provided insight into the workings of Pyongyang’s financial network. The designations included the following: Han Jan Su, the Moscow-based representative of U.S.-designated Foreign Trade Bank; Jo Chol Song, the Dandong, China deputy representative of U.S. and U.N.-designated Korea Kwangson Banking Corporation; Kim Tong Ho, the Vietnam-based representative of U.S. and U.N.-designated Tanchon Commercial Bank; Kim Mun Chol, the Dandong-based representative of U.S. and U.N.-designated Korea United Development Bank; and Kim Nam Ung and Choe Chun Yong, the Moscow-based representatives for IIsim International Bank.<sup>24</sup> These representatives were engaged in a variety of conduct including working with RGB on financial transfers, working with Moscow-based Tempbank that was designated by the U.S. for its activities with the Syrian regime, and weapons and missile-related sales.<sup>25</sup>
- *North Korean Banks in China*: The U.N. Panel of Experts reported that U.S.-designated Daedong Credit Bank (DCB) and U.S.-designated Korea Daesong Bank (KDB) are operating in China using representative offices in Dalian, Dandong, and Shenyang.<sup>26</sup> The U.N. reported that U.S.-designated Kim Chol

grams”, September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>18</sup>“In China’s Shadow”, The Asan Institute for Policy Studies and C4ADS, August 2016. (<https://static1.squarespace.com/static/566ef8b4d8af107232d5358a/t/57df7e74acd0f68d629357306/1474291539480/In+Chinas+Shadow.pdf>) U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged With Using Front Companies To Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs”, September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>19</sup>U.S. Department of Justice, Press Release, “Four Chinese Nationals and China-Based Company Charged With Using Front Companies To Evade U.S. Sanctions Targeting North Korea’s Nuclear Weapons and Ballistic Missile Programs”, September 26, 2016. (<https://www.justice.gov/opa/pr/four-chinese-nationals-and-china-based-company-charged-using-front-companies-evade-us>)

<sup>20</sup>U.S. Department of the Treasury, “Press Release: Treasury Imposes Sanctions on Supporters of North Korea’s Weapons of Mass Destruction Proliferation”, September 26, 2016. (<https://www.treasury.gov/press-center/press-releases/Pages/jl5059.aspx>)

<sup>21</sup>United Nations Security Council, “Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)”, S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>22</sup>United Nations Security Council, “Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)”, S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)

<sup>23</sup>Ibid.

<sup>24</sup>U.S. Department of the Treasury, “Press Release: Treasury Sanctions Agents Linked to North Korea’s Weapons of Mass Destruction Proliferation and Financial Networks”, March 31, 2017. (<https://www.treasury.gov/press-center/press-releases/Pages/sm0039.aspx>)

<sup>25</sup>U.S. Department of the Treasury, “Press Release: Treasury Sanctions Syrian Regime Officials and Supporters”, May 8, 2014. (<https://www.treasury.gov/press-center/press-releases/Pages/jl2391.aspx>) U.S. Department of the Treasury, “Press Release: Treasury Sanctions Agents Linked to North Korea’s Weapons of Mass Destruction Proliferation and Financial Networks”, March 31, 2017. (<https://www.treasury.gov/press-center/press-releases/Pages/sm0039.aspx>)

<sup>26</sup>United Nations Security Council, “Report of the Panel of Experts Established Pursuant to Resolution 1874 (2009)”, S/2017/150, February 27, 2017. (<http://undocs.org/S/2017/150>)



Sam operated a financial network inside China, including millions of U.S. dollar transactions, without apparent repercussions from Beijing.<sup>27</sup>

These are some examples of how the North Koreans continue to engage in illicit commerce and financing by leveraging their ties, facilities, and agents in China. More research attention and disclosures of these kinds of networks will continue from the media and scholars like Anthony Ruggiero at the Foundation for Defense of Democracies and our Center on Sanctions and Illicit Finance and analytic firms like C4ADS and Sayari. The dependency of the North Korean economy on the Chinese system raises the difficult question of what more can be done to pressure China to crack down effectively on the regime in Pyongyang.

#### **Killing the Chicken To Scare the Monkey: Secondary Sanctions and Beyond**

This Subcommittee has asked to focus on the potential use of secondary sanctions to impact those entities in China that continue to do business with North Korea. Secondary sanctions are not a common tool in the various U.S. sanctions regimes, but they have been employed or implicated recently in sanctions programs against Iran, Hizballah, and in the Russia/Ukraine context.

Secondary sanctions entail imposing sanctions or restrictions against third-country parties for transactions with no U.S. touch points or traditional nexus. The goal of secondary sanctions with jurisdictions or regimes is to force a foreign third-party to choose between doing business in the United States or doing business in the targeted jurisdiction. Such sanctions apply to all persons (natural and legal) on a global basis, regardless of the person's connection with the United States. Those sanctioned are then subject to various potential penalties that restrict their ability to access the U.S. market.

In the Iran context, U.S. secondary sanctions primarily targeted certain sectors and exports directly relevant to the Iranian economy and prohibited foreign financial institutions from conducting any significant transactions in Iranian currency. The United States used these sanctions to restrict Iran's activities and squeeze their economy. Their greatest effect may have been in the potential application of such sanctions and the resulting chilling effect on market and commercial activity—even absent designations.

Secondary sanctions are not without problems or controversy. Other countries and foreign parties see them as the most aggressive extra-jurisdictional application of American economic power and influence—leveraging access to U.S. markets as a tool of coercive economic statecraft. They are also effective only if they can be credibly threatened and applied. This is not the case when those engaged in the activity of concern have no desire to deal with the United States and no potential exposure making them subject to sanction or financial or economic isolation. These can also appear to be toothless sanctions if the categories of potential institutions or sectors targeted are “too big to sanction.”

To the Chinese, the potential application of primary or secondary sanctions to their citizens, companies, or interests will be seen as a challenge to their sovereignty. Consistently, the Chinese have objected to any form of unilateral sanctions that fall outside of the auspices of the United Nations, and any financial or commercial measure that has the effect of sanctioning a Chinese party will engender a negative reaction. In addition, China has tended to defend against more aggressive application of Chapter 7 U.N. sanctions, and it has often been lax in enforcing sanctions regimes when Chinese interests are at play, as in the case of North Korea.

In the current context, North Korea appears to rely less on major Chinese global banks and financial institutions directly for access to financing and banking services. North Korean financial and commercial activity has tended to concentrate in recent years with smaller Chinese banks and entities to facilitate financial and commercial activity and with many entities with little to no connectivity to the United States. Even so, more research and analysis is uncovering deeper and more entangled commercial, transport, and financial ties between the Chinese and North Korean economies. The direct and indirect exposure by major Chinese companies and banks to North Korea may not be fully known or appreciated, perhaps not even to those institutions.

Though Chinese sensitivities have to be kept squarely in mind to ensure greater cooperation, there needs to be a more comprehensive set of tools that attempt to squeeze the Kim regime's access to financing and commercial outlets, sensitizes the markets to the risks of doing business with North Korea, and begins to demonstrate a willingness to expose and target key nodes and conduits of North Korean financial and commercial activity.

<sup>27</sup> Ibid.

In that context, it is appropriate to consider creating secondary sanction authorities that target those entities—of whatever country of origin that continue to do business with North Korea in certain sectors of concern. The mere threat of secondary sanctions—regardless of sectors identified—would condition Governments and the private sector to engage in deeper due diligence to understand better where North Korean agents, networks, and entities are accessing capital and resources. It would result in North Korean accounts being shut down, activity locked out of the financial system, and agents attempting to recast their businesses and identities to avoid scrutiny.

The risk from direct or indirect exposure to North Korea would be a serious concern for the major Chinese banks—the Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agriculture Bank of China—trying to establish legitimate and sustainable footholds in the United States and other Western markets. Even if these banks did not have direct business ties with North Korea, they would have to ensure that their counterparties, correspondents, and clients did not expose them to the threat of secondary sanctions or enforcement actions in the United States. The risk of being cut off from U.S. markets would be too great a risk to ignore for legitimate actors in the banking, shipping, and commercial worlds.

The mere existence of the authority does not mean it has to be used in each instance of a violation. The authority would open up economic and diplomatic dialogue with concerned actors that could result in changed behavior, more information, and the cut off of commercial relations with North Korea—even without designating any entities. The use of such authority may ultimately be shaped or constrained by diplomatic considerations, but this tool could provide diplomatic leverage that does not currently exist with North Korea and China.

Secondary sanctions authority, though important, would not be the only step the United States could take unilaterally and in concert with international partners and the private sector to pressure North Korea, including in and through China. As with any effective sanctions program, there needs to be a commitment of analysis, investigations, targeting, and follow-up—constantly undertaken to counteract the evasion and masking techniques used by nefarious actors. And such efforts cannot be left to the United States alone, though it will need to lead any such effort.

The following are other steps that should be taken to address the risks from North Korea and catalyze Chinese and other actors to do more to prevent North Korea from accessing the financial and commercial system.

- *North Korean “Class of Transaction” 311 Designation.* On November 9, 2016, the U.S. Treasury designated North Korea a “primary money laundering concern” and prohibited any correspondent accounts with North Korean financial institutions or the facilitation of any transaction from a North Korean financial institution. This was a very important step and a signal to the financial community of the seriousness of the risks to the integrity of the financial system and international community posed by North Korea. This step should be amplified by designating any North Korea financial and commercial transaction or activity as a class of transaction of “primary money laundering concern” and requiring specific enhanced due diligence, information collection, and reporting tied to any transactions touching North Korean activity—inside or outside of the country. This would put the onus on financial institutions, in particular Chinese banks with exposure to the United States and Western banking systems, to determine if they have direct or indirect exposure to anything that touches North Korea. This scrutiny goes beyond designated North Korean banks or entities—whose names and affiliations may change—and more broadly to the suspect nature of any transaction that touches North Korea.
- *Dynamic Financial Information Sharing With Private Sector.* The U.S. Government, in concert with Japan, South Korea, Australia, and other allies in Asia, should establish a dynamic information sharing mechanism with key private sector actors to explain and share where potential exposure to suspect North Korean activity lies. Financial intelligence units could be tasked with compiling data and reports that could be disseminated, with a goal of targeting and exposing more North Korean financial and commercial activity more quickly. Banks, shipping companies, and the insurance sector would welcome more information that would allow them to comply with relevant sanctions and understand where risk lies within their businesses. This could follow other models and platforms being created in the banking industry to share more specific information about specific risks and threats.
- *Regulatory and Enforcement Attention to Chinese Banks.* Authorities in the United States, Western, and Asian countries have begun to devote more regu-

latory and enforcement attention to Chinese banks operating abroad for failure to have adequate financial crimes and sanctions compliance risk management. This is an important shift in attention, as Chinese banks seek to meet international global standards for transparency, sanctions compliance, and financial crimes risk management. Billions of dollars of fines against European, American, and other Western banks have focused the attention of banks to improve their sanctions compliance. Scrutiny over Chinese banks' lack of adequate financial controls and a culture of compliance—as has happened with other global banks—would further sensitize Chinese institutions to the risks presented by exposure to North Korea.<sup>28</sup>

- *Anti-Corruption Initiative.* The United States should launch an anti-corruption initiative to investigate and build public cases against corrupt North Korean actors and those who are colluding with them, perhaps using a new executive order to focus targeted sanctions on North Korean kleptocracy. Such sanctions and any related cases exposed would focus attention on the amount of wealth and corruption within the regime leadership and the ties that they have with others outside of North Korea. The Chinese would be concerned about North Korean corruption bleeding into their system and implicating Chinese actors. This would likely prompt greater attention to North Korean ties and lead to more Chinese actions to shut down illicit or corrupt networks of concern.
- *Leadership Asset Hunt.* In conjunction with this, the United States should declare that it is launching a leadership asset hunt for assets stolen and held by the Kim leadership, using the tools and resources of the intelligence community, law enforcement, and regulators and working with international institutions like the World Bank's Stolen Asset Recovery Initiative. The goal would be to determine how the senior leadership of the regime in Pyongyang holds and stores its money outside of North Korea and with whom it is dealing and operating. This could have direct implications for China and could expose where North Korea and China maintain existing financial relationships. This would further shine a spotlight on suspect "Politically Exposed Persons" requiring additional due diligence and attention by the Chinese and other banking systems.
- *Human Rights and Sanctions.* The United States should expand the list of companies and entities subject to sanctions under Executive Order 13722 (March 15, 2016), including considering designating those companies employing North Korean workers and paying their fees directly to the North Korean regime. It should call on countries currently allowing this practice to shut it down and push for human rights designations at the U.N. and a prohibition on paying North Korea for overseas laborers.<sup>29</sup> This should be matched with a Treasury advisory to financial institutions warning against facilitating or engaging in any transaction related to this forced labor.
- *Shipping: Mapping and Interdictions.* The United States in concert with Japan, South Korea, Australia, and other allies should coordinate the sharing of North Korean shipping and transport data—along with private sector actors to track and map shipping interests doing business with or in North Korean ports or waters. The mapping and investigation of shipping tied to North Korea would allow for more robust information sharing and understanding where the proliferation and trafficking risks lie and would expose networks and business interests of concern. This would also enable more robust maritime interdiction strategies, which would put pressure on those countries or entities that continue to do business with North Korea.
- *North Korean Illicit Activities Enforcement Initiative.* The law enforcement and intelligence communities—in concert with the U.N. Panel of Experts and the private sector—should concentrate on understanding and exposing North Korea's continuing illicit commercial and financial activity. Smuggling, money laundering, arms trafficking, and sanctions evasion should all be subject to intense investigation and exposure and should be a priority for law enforcement in Asia and wherever North Korea engages in commercial activity. An illicit activity initiative would allow for more disruptions, designations, and identification where illicit networks are operating with impunity. This could be done in

<sup>28</sup> Anthony Ruggiero, "Severing China–North Korea Financial Links", Center for Strategic and International Studies, April 3, 2017. (<https://www.csis.org/analysis/severing-china-north-korea-financial-links>)

<sup>29</sup> Anthony Ruggiero, "Don't Let North Korea's Nukes Overshadow Human Rights Abuses", *The Hill*, April 28, 2017. (<http://thehill.com/blogs/pundits-blog/foreign-policy/331061-dont-let-north-koreas-nukes-overshadow-human-rights-abuses>)

concert with the Chinese to underscore the need to attack illicit financing networks.

- *Cyber Litigation—Private Rights of Action.* To match existing sanctions targeting those involved in undermining cybersecurity, Congress should consider providing victims of North Korean cyberattacks the right to sue and seek damages from entities and actors that have facilitated or knowingly benefited from North Korean cyber activity. This is important as North Korea expands its cyber footprint and attacks. Though this may not reach into Pyongyang, this right of action would put private sector actors that deal with North Korean or other cyber belligerents on notice that they could be subject to private litigation and suits.

These are just some of the ideas that can be woven into a strategy that includes secondary sanctions. These tools—if leveraged and choreographed wisely and in concert—would not only squeeze the North Korean regime but also compel the Chinese to consider its own ties and the risks of exposure to North Korea.

### Changing the Chinese Calculus

There is reason to believe that the Chinese calculus and behavior can be affected if North Korean actions and taint threaten the fundamental interests and reputation of the Chinese economy, leadership, and system. There are hopeful signs in recent months and past episodes that provide a window into Chinese thinking and can be guideposts for any pressure campaign.

China has been willing to exert pressure and crack down on its trade with North Korea when it has faced public scrutiny over such ties, or when it wishes to express selective disapproval over North Korean actions. In September 2016, it was reported that China had opened an investigation into the Chinese citizen, Ma Xiaohong, who was indicted by the United States. She ran the Dandong Hongxiang Network, which had allegedly undertaken half a billion dollars in trade with North Korea between 2011 and 2015,<sup>30</sup> some of which “included materials that can be used in the production of nuclear weapons.”<sup>31</sup> China has reportedly frozen her assets.

In February and April of this year, China curbed its imports of coal from North Korea, likely in response to recent multiple missile tests Pyongyang carried out and in the wake of the assassination of Kim Jong-Un’s half-brother in Malaysia via a VX nerve agent.<sup>32</sup> Furthermore, in May 2013, the Bank of China closed the account belonging to Foreign Trade Bank, “North Korea’s most important financial institution”, which had been sanctioned by the U.S. in March of that year.<sup>33</sup> These actions do not necessarily signal a fundamental shift in Chinese policy, but it reflects a willingness to take actions against North Korean interests and connections in China.

In addition, the Chinese Politburo held a study group last month focusing on “financial security,” signaling that the Chinese leadership is attaching a high priority to this topic. The United States could work with the Chinese to focus on protecting the Chinese, U.S., and broader financial system from the collective threats of illicit activity, cyberfinancial attacks, and corruption that North Korea represents, especially to Chinese banks.

In the past, there have been key episodes that demonstrate the Chinese system’s sensitivity to the risks North Korea represents to its own economy and reputation—and a willingness to cooperate and change their risk calculus as a result of a changed landscape.

*Banco Delta Asia (BDA).* In September 2005, as part of a strategic pressure campaign, the Treasury Department ordered U.S. financial institutions to close correspondent accounts for a private bank in Macau—Banco Delta Asia (BDA)—pursuant to Section 311 of the Patriot Act. This bank—designated as a “primary money laundering concern”—was facilitating money laundering, proliferation, and counterfeiting on behalf of the North Korean regime.

<sup>30</sup> James Pearson, “China Probes North Korea Bank Suspected of Nuclear Link—South Korea Paper”, Reuters, September 26, 2016. (<http://www.reuters.com/article/us-northkorea-nuclear-bank-idUSKCN11W049>)

<sup>31</sup> Jane Perlez and Chris Buckley, “China Announces Inquiry Into Company Trading With North Korea”, *New York Times*, September 20, 2016. ([https://www.nytimes.com/2016/09/21/world/asia/north-korea-china-inquiry-hongxiang.html?\\_r=0](https://www.nytimes.com/2016/09/21/world/asia/north-korea-china-inquiry-hongxiang.html?_r=0))

<sup>32</sup> John Ruwitch and Meng Meng, “North Korean Ships Head Home After China Orders Coal Returned”, Reuters, April 11, 2017. (<http://www.reuters.com/article/us-china-northkorea-coal-exclusive-idUSKBN17D0D8>)

<sup>33</sup> Jane Perlez, “U.S. Sanctions Expected To Hit Small Banks’ Business With North Korea”, *New York Times*, June 3, 2016. (<https://www.nytimes.com/2016/06/04/world/asia/us-sanctions-expected-to-hit-small-banks-business-with-north-korea.html>)

The regulation cut the bank off from the U.S. financial system. More important, the unilateral regulation unleashed a wave of financial isolation against North Korea. Banks in China, Asia, and Europe stopped doing business with North Korea, denying it access to the international financial system. North Korean bank accounts were closed, its transnational commercial transactions were canceled, and officials' financial activities were carefully scrutinized.

This hurt Pyongyang. The North Korean regime scrambled to regain access to money and accounts around the world while trying to undo the official damage done to its reputation in the international financial community. Key State actors, including China, had no incentive to block the full effect of the market reaction. On the contrary, they did not want their banks or financial reputations caught up in the taint of North Korea's illicit financial activity.

This pressure became the primary leverage for the United States to press for North Korea's return to the six-party negotiating table. Once the six-party talks reassembled, the financial pressure campaign against North Korea ended, resulting in a loosening of the financial squeeze.

Unlike traditional State-based sanctions, this kind of financial leverage relies more on the risk-based calculus of global financial institutions than the policy decisions of Governments. For legitimate financial institutions, there are no benefits to the risk of facilitating illicit transactions that could bring high regulatory costs and damage to their reputations if uncovered. If financial institutions act according to their own interests, targeted actors and their suspected fronts will be denied access to the facilities of the international financial system. In this case, the Chinese financial institutions defended their own interests and reputations, not putting themselves at risk on behalf of the North Koreans.

*Kunlun Bank.* On January 31, 2012, the U.S. Department of the Treasury sanctioned Bank of Kunlun Co. Ltd., a Chinese bank under the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA) for providing "significant financial services" to at least six Iranian banks designated by the Treasury.<sup>34</sup> Bank of Kunlun transferred nearly \$100 million from accounts it held for Bank Tejarat and made at least one payment for an affiliate of the Iranian Revolutionary Guard Corps.<sup>35</sup> At the time, Chinese Foreign Ministry Spokesman Qin Gang urged the U.S. to lift sanctions against the Bank of Kunlun, stating that the imposition of U.S. sanctions "violates the norms of international relations and damages China's interests."<sup>36</sup><sup>37</sup> Despite the protestations and fears of Chinese backlash, the Chinese quietly dealt with Kunlun Bank and directed it to stop such activities.

*Chinese Position Shift on Sudan ICC Indictment.* At a recent Harvard Law School panel discussion, the first Chief Prosecutor of the International Criminal Court (ICC), Jose Luis Moreno Ocampo, provided an instructive example of a Chinese policy shift during his tenure. Ocampo noted that the Chinese position regarding the ICC's investigation of the Bashir regime in Sudan had always been to support and defend it because President Bashir guaranteed the stability of Sudan. The Chinese position changed in the face of the Bush administration's forceful support of the ICC's indictment of President Bashir of Sudan, leading the Chinese to conclude that Bashir no longer represented stability and began to explore other options. According to Ocampo, the Obama administration's consolidation of Bashir's stability led to the consolidation again of China's support to the regime in Sudan.

Indeed, the Chinese will not want to react directly to pressure, but they will understand when their interests are directly affected by the taint, attention, and illicit activity of the North Koreans. We have seen this already with the discomfort China has felt and expressed with the deployment of the THAAD missile defense system in South Korea and the increased U.S. maritime presence in Asian waters. If the Chinese see that their interests and credibility will be undermined fundamentally by connectivity and support to North Korea, the less likely they are to allow those financial and commercial ties to exist. If they understand that exposure to North Korea will bring greater scrutiny to issues like corruption, human rights abuses,

<sup>34</sup>"Treasury Sanctions Kunlun Bank in China and Elaf Bank in Iraq for Business With Designated Iranian Banks", Department of the Treasury Press Release, July 31, 2012. (<https://www.treasury.gov/press-center/press-releases/Pages/tg1661.aspx>)

<sup>35</sup>"Exclusive: Iran Uses China Bank To Transfer Funds to Quds-Linked Companies—Report", Reuters, November 18, 2014. (<http://www.reuters.com/article/us-iran-sanctions-china-exclusive-idUSKCN0J20CE20141119>)

<sup>36</sup>"China Hits Back at New U.S. Sanctions Over Iran", Kelly Olsen, *AFP*, August 1, 2012. (<https://www.yahoo.com/news/china-hits-back-us-sanctions-over-iran-063058172.html>)

<sup>37</sup>Wayne Ma, "China Scolds U.S. Over Iran-Related Bank Sanctions", *Wall Street Journal*, August 1, 2012. (<https://www.wsj.com/articles/SB10000872396390444320704577562330527832056>)

and financial crimes in China and Chinese institutions, then the Chinese calculus will have to change.

This is a moment of growth and expansion for the Chinese banks and commercial brands, with many establishing footholds in Western economies. If protecting the North Korean economy or regime represents a real threat—direct or indirect—to the credibility and strength of the Chinese banking sector and the future stability and growth of the Chinese economy, the Chinese may not elect to maintain suspect commercial and financial ties with North Korea. The potential application of secondary sanctions could affect this calculus and move the Chinese to place more serious pressure on Pyongyang.

### Caution and Caveats

When considering secondary or other types of sanctions with respect to China, policymakers and national security strategists have to take into account the size and significance of the Chinese economy. The second largest economy in the world, growing to become the leading economy in this century, with its deep trading and investment ties in the United States and the West cannot be isolated or treated as a target of a maximalist financial and commercial pressure campaign. In addition, our need to cooperate and compete with—as well as confront—China in many other arenas, including in the South China Sea and cyberspace, limits how far we may go with our financial and economic toolkit.

There are too many costs to U.S. interests if a maximalist approach were attempted, with boomerang effects on the U.S. economy, trade, and U.S. and allied interests in China and Asia. China could always retaliate with sanctions of its own against U.S. interests, as they have threatened recently after the announced sale of U.S. high-end military equipment to Taiwan. And China can use its own resources and economic power to express its diplomatic displeasure, as it has done in the recent past with Japan by restricting the export of rare-earth minerals in 2010, allowing bananas from the Philippines to rot in port in 2012, and placing sanctions on South Korean companies for allowing the deployment of the THAAD missile defense system in early 2017.<sup>38</sup> The Chinese dragon knows how to bite and to use financial and economic tools—in the physical and virtual worlds.

In addition, any new pressure campaign has to consider the potential for asymmetric attacks from North Korea, especially attacks on the financial system. North Korea has increased its capabilities and increased the pace of its probing cyberattacks. The North Korean hacking group Lazarus has reportedly targeted organizations in 31 countries, including the November 2014 Sony hack in the United States, the \$81 million heist from the Bangladesh Central Bank,<sup>39</sup> and banks and broadcasting companies in South Korea.<sup>40</sup> North Korean hacking activity has increased this year, with reports that banks in the United States, Poland's biggest bank lobbying group ZBP, and banks throughout the world have been targeted by North Korean entities.

This is not an attempt to give credence to a heckler's veto. Instead, this is a cautionary note that any effective action taken in the financial and economic domain may result in reactions by those targeted or affected by U.S. actions. The United States—and the private sector—must be prepared for such a reaction. In addition, there will be limits to what can be done in this domain, but the United States should always try to use the most effective and appropriate means to pressure the North Korean regime. The United States and her allies should not pull punches just because the effects of those actions may implicate China. If secondary sanctions can help squeeze the North Korean regime and help shift the Chinese calculus, then they should be authorized and used, in concert with other tools.

<sup>38</sup>Tom Miles and Krista Hughes, "China Loses Trade Dispute Over Rare Earth Exports", Reuters, March 26, 2014 ([http://www.reuters.com/article/us-china-wto-rareearth-idUSBREA2P0ZK20140326](http://www.reuters.com/article/us-china-wto-rareearth/idUSBREA2P0ZK20140326)); Andrew Higgins, "In Philippines, Banana Growers Feel Effect of South China Sea Dispute", *Washington Post*, June 10, 2012 ([https://www.washingtonpost.com/world/asia\\_pacific/in-philippines-banana-growers-feel-effect-of-south-china-sea-dispute/2012/06/10/gJQA47WVTV\\_story.html?utm\\_term=.493ab5719154](https://www.washingtonpost.com/world/asia_pacific/in-philippines-banana-growers-feel-effect-of-south-china-sea-dispute/2012/06/10/gJQA47WVTV_story.html?utm_term=.493ab5719154)); Elizabeth Shim, "China Sanctions, Hacking Threats Eclipse South Korea THAAD Deployment", UPI, March 7, 2017. ([http://www.upi.com/Top\\_News/World-News/2017/03/07/China-sanctions-hacking-threats-eclipse-South-Korea-THAAD-deployment/9311488902166/](http://www.upi.com/Top_News/World-News/2017/03/07/China-sanctions-hacking-threats-eclipse-South-Korea-THAAD-deployment/9311488902166/))

<sup>39</sup>Jim Finkle, "Cyber Security Firm: More Evidence North Korea Linked to Bangladesh Heist", Reuters, April 3, 2017. (<http://www.reuters.com/article/us-cyber-heist-bangladesh-northkorea-idUSKBN175214>)

<sup>40</sup>Jim Finkle, "North Korean Hacking Group Behind Recent Attacks on Banks: Symantec", Reuters, Mar 15, 2017. (<http://www.reuters.com/article/us-cyber-northkorea-symantec-idUSKBN16M37J>)

**Conclusion**

It is time to test if China and the United States together can influence the North Korean regime—and stop its march toward nuclear weapons capabilities that threaten the U.S. homeland. China has the opportunity to prove its role as a great power and to use its influence with Pyongyang. The clock is ticking, and an effective financial pressure campaign with China on side is one way of helping to slow, if not stop, the clock.