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Financial Warfare: Money as an Instrument of Conflict and Tension in the International Arena

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Dedication and Acknowledgements

I would like to dedicate this thesis to my family. To my father, who never fails to remind me that 99 out of 100 means I got something wrong, and is always up for witty banter. To my mother, who has given me constant love and support, and has been my rock. To my brother, who has shown me that people who say little have much more powerful words than those who say a lot. To my grandpa, for all of the Krugman articles throughout the years. To my nonno, for telling me to shoot for the stars.

I would also like to thank my senior project advisor, Dr. Pavlina Tcherneva, for all of her invaluable input throughout the entire process, and helping me develop my theoretical framework for this project. Dr. Tcherneva's support throughout my undergraduate career at Bard has been instrumental in my development as an economics student, and I am forever grateful. I would also like to thank my other economics professors who have played a key role in shaping my education in economics: James Andrew Felkerson, Dr. Olivier Giovannoni, Dr. Sanjaya DeSilva, Dr. Aniruddha Mitra, and Dr. James Green-Armytage.

I would also like to thank my friends, who kept me sane during this demanding senior year.

Abstract

This project employs a historical, institutionalist, and legal approach to analyzing financial warfare, specifically utilizing a chartal-spatialist theory of money. Utilizing these theories in conjunction with historical case studies, a theory of financial warfare is developed through understanding money as a product of social stratification and hierarchy, and therefore that the creation of money itself is a process of power. The spatiality of a powerful money expands beyond its national borders, and hence there is a hierarchy within money itself in the international arena. To build the theory, this project includes three case studies of implementations of financial warfare, each of which add a piece to the overall story: counterfeiting, financial sanctions policy, and counterterrorism through the dismantling of terrorist organizations' financial networks. As such, through focusing on money as an instrument of conflict and tension, the theory of financial warfare developed in this project focuses on the strength of a country's currency, as well as its position in the international financial system. Given the fact that hegemony is relative, the theory outlines preconditions for successfully implementing financial warfare, which include having higher financial power relative to the target country, having macroeconomic flexibility through issuing a strong sovereign currency, and having an elastic access to the law as defined in Katherina Pistor's legal theory of finance. This project further concludes that given its position as the issuer of the global reserve currency and the central authority in the international financial system, the United States is in the highest position of power to implement financial warfare.

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Introduction

"In economics, the majority is always wrong."
- John Kenneth Galbraith

We use theory to understand what is happening in the world around us, to understand our surroundings, to understand complex social relationships. Theory serves as the bridge between what is real and what we can comprehend. We create disciplines like economics to organize our theory around our constructed categories of real world phenomena. Economics has broadly been defined as the study of how people use their resources, act under limits of scarcity, and make decisions about production and distribution.[1] It is something that we as humans have created to understand how the world works and how people behave. Whenever people misconstrue my major to be something more related to finance or accounting, I have always been quick to correct them, saying that economics is not only about money and financial markets, but instead it is a social science whose aim is to create a framework through which we can comprehend the decision making processes of people and institutions and explain complex social relationships.

With that said, this project is about money and financial markets, and the hierarchy that exists within them. The aim of this project is to understand money as a source of international conflict and tension through employing historical, institutional, and legal analysis with an emphasis on the chartalist-spatial theory of money. After all, economics is most interesting when married with other disciplines. This project takes cases that have happened throughout history, seeks to understand them through the lens of these analytical approaches, and develops a theory of financial warfare. The theoretical backbone of this paper is the Chartalist notion of the origins of money, the theoretical alternative to the mainstream economic notion of money creation, Metallism. While scholars from other disciplines, such as historians, anthropologists, and numismatists embrace the Chartalist notion of money being a creature of the state, the economics profession stubbornly stands alone adhering to a paradigm of money creation, which unlike Chartalism, lacks historical support. Only a relatively small group of economists outside of the profession's mainstream stand by chartalism.

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[1] Definitions retrieved from the American Economic Association.

This divergence in thought surrounding the origins of money characterizes the plight of the economics profession. Rather than questioning the robustness of existing theory accepted in the mainstream when it cannot adequately explain things such as counterfeiting, economists instead remain steadfast in maintaining their existing thought structure, dismissing counterfeiting as an irregularity in the system, rather than a social phenomenon that is something so much more than that. This is what this project seeks to do. The existing economic literature on financial warfare is sparse at best, as counterfeiting and sanctions policy do not fit neatly into existing models.[2] If financial warfare were analyzed through the lens of Metallism, it would be relegated as theoretically unimportant by simplifying it to mere irregularities. However, the aim of this project is not to simplify, and the task set by this project of understanding financial warfare through its monetary underpinnings was not easy.

This project consists of four chapters. The first chapter outlines the multidisciplinary theoretical framework of this project's approach to understanding financial warfare through the notion of the spatial hierarchy of the dollar. Using this framework, we will be identifying the hegemonic position of the dollar. The following three chapters include case studies surrounding three different implementations of financial warfare: counterfeiting, financial sanctions policy, and counterterrorism efforts through financial means. The first two of these three chapters build upon the major themes of monetary hegemony and power. Counterfeiting speaks to how sovereignty is recognized, as well as enforced and/or challenged, through money. Additionally, the chapter concludes with the notion that the motives behind counterfeiting between nations are twofold. One reason a nation counterfeits another nation's currency is purely as an act of war, with no other purpose for the counterfeited notes. Another is that a nation is not only counterfeits as a means of attack, but also because they need the currency they are forging, and thus are submitting to the sovereign. In the next chapter, financial sanctions are analyzed as an extension of the sovereign via the spatial influence of its money. A powerful money, such as the dollar, effectively expands the legal jurisdiction of its issuing sovereign. The last chapter marries everything together in the U.S.'s innovative use of its hegemonic power to deter terrorist finance. Using its power as the central

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[2] With that said, there is small amount of existing literature on counterfeiting and financial sanctions, as will be presented in Chapters 2 and 3.

authority of the international financial system, the U.S. was able to develop financial intelligence and impose financial isolation on risky entities to expose and eradicate the underground financial networks of terrorist organizations. With each real world case presented in this paper, theories across different disciplines are being synthesized to understand its significance, with monetary economic theory at the core.

Lastly, financial warfare can expand to cover a wide array of occurrences, such as issues pertaining to cybersecurity, counterfeiting by private sector institutions versus governmental institutions, as well as corporate globalization and exploitation, like what we see in the oil industry. However, the definition of financial warfare used in this analysis is undermining the power of the sovereign by either directly attacking its money, or blocking its access to money and credit. At the essence of this definition is money as creature of the sovereign and power. As such, the major theme of this project is how money determines power in the international arena, and how can it be used to exercise power in instances of conflict and tension. As such, this project will not only contribute to the sparse economic literature surrounding financial warfare, but it will also expand the existing Chartalist literature as well, given that the existing Chartalist literature does not analyze the implications of money being a creature of the state in the international struggle for power amongst countries. Furthermore, this project also is an extension of Pistor's legal theory of finance, as Pistor primarily focuses on economic crises, while this analysis also addresses how the elasticity of the law impacts a country's behavior in national security issues and international affairs.

We utilize theory to explain what is happening around us in the real world, for what use is theory if it cannot explain real world phenomena? The real world is messy, and the social relationships that comprise economics are complex and full of irregularities, but it is the responsibility of the economist to adapt their theory to encompass explanations for these phenomena, rather than only explore that which fits neatly into their preconceived notions of how the world works through flawed theory.

1. Literature Review and Theoretical Framework

1.1: A Brief History

Financial warfare has been around as long as traditional warfare by military action. However it has evolved in form over time. Looking at a brief history of financial warfare will illustrate this evolution, and show how various methods of financial warfare have been used over time with the same goal in mind: undermining the sovereign power of a country or organization. Not only will a historical overview demonstrate the efficacy of financial warfare as a means of coercion or weakening an opposing entity, but also the possible counter-effects of its implementation.

One of the earliest instances of financial warfare can be found in the Bible. In II Kings, the story of a conflict between Israel and Moab is told, recounting the complementary use of both military intervention as well as an economic attack. When the Moabites attempted to invade an Israeli camp, the Israelites rose up in military force and drove them out. However, Israel wanted to go further than that single decisive military victory. Thus, the Israelites came to Moab and inflicted widespread economic destruction on its land (Taylor 1998). They destroyed towns and cities, ruined fields by throwing stones on them, cut down trees, and stopped springs. The King of Moab was forced to surrender and offer his firstborn son, the successor to the throne, as a sacrifice. Through the economic destruction of their country, the Moabites were forced to surrender, and the Moabite economy was left uninhabitable after this conflict (Taylor 1998).

Financial warfare also led to the demise of the powerful ancient Greek city-state of Athens, who underestimated the potency of sanctions, and therefore Sparta's subsequent backlash. Before the Peloponnesian War in 432 B.C., Athens and Sparta were the two strongest city-states in Ancient Greece; while Sparta was a military power, Athens was an economic power. Each led an opposing coalition of city-states (Zarate 2013: 3). It is debated whether or not the Peloponnesian War broke out between Athens and Sparta as a result of a conflict over the city of Megara, which at that point in time was aligned with Sparta (World Heritage Encyclopedia). Rather than use military action, which Athens knew was an area of comparative disadvantage relative to Sparta, Athenian politicians decided to impose economic sanctions on Megara, which became known as the Megarian Decree. Thus, Athens excluded Megarian merchants from the ports and markets of the Delian League, which was allied with Athens, with the intention of avoiding war with Sparta. With their economy starved of resources, Megara turned to Sparta for aid, and Sparta declared to Athens that the economic sanctions be lifted. When Athens refused, Sparta declared war. The war ended with the subjugation of Athens by Sparta, ending the Athenian Golden Age (Zarate 2013: 4).

During the American Revolution, the British sought to weaken the colonies not only by military means, but also by financial means. Aboard the HMS *Phoenix*, a gunboat anchored in New York harbor, the British counterfeited American currency. The counterfeit notes were distributed throughout the American colonies by colonists loyal to the British, one of the most famous being Stephen Holland. Holland organized an elaborate network of distributors, but eventually he was caught (Rhodes 2012: 34). Counterfeiting was as effective of a weapon as military force, and potentially capable of more long-term damage. Counterfeiting was therefore an act of war during the American Revolution, and its popularity as a tool of warfare increased alongside the development of currency systems. Furthermore, Benjamin Franklin noticed another nuance pertaining to currency and warfare: printing the counterfeit continental currency was indeed an act of war, but printing genuine continental currency was also an act of war, symbolizing the American colonies' sovereignty, and thus their dissociation from the British regime. During the American Civil War almost a century later, counterfeiting was similarly used as an act of war in both regards, and President Abraham Lincoln created the Secret Service, whose sole purpose at its creation was to seek out counterfeiting operations, thwart them, and arrest the persons involved (Rhodes 2012: 36).

One of the most interesting counterfeiting operations in history occurred during World War II. In order to weaken the British economy, the Nazi's developed counterfeiting operations to cause economic and financial distress in Great Britain. They ran the counterfeiting operations out of their concentration camps, where they identified skilled printers and engravers amongst the prisoners and brought them together to work on this project at the Sachsenhausen concentration camp (Rhodes 2012: 37). This counterfeiting program was launched by SS officers Alfred Naujocks and Bernhard Kruger of the Reichsicherheitshauptamt (the German Security Main Office, or RHSA), and was primarily overseen by Bernhard Kruger, the project's namesake. Operation Bernhard was not in full operation until 1942, and it has been said that the outcome of the war could have been a lot different if this counterfeiting program had been launched in 1939 or 1940 (Ruffner 2014: 42).

During the 1956 Suez Crisis, to prevent the nationalization of the Suez Canal by Egypt, the British and French landed forces in the Suez Canal. The United States was opposed to this, but with Great Britain and France being NATO allies, the U.S. could not use military intervention. Thus, President Dwight D. Eisenhower skirted NATO regulations by implementing financial warfare as a way to coerce Great Britain and France into leaving the Suez Canal without any direct military action on the part of the U.S. Eisenhower ordered the Department of the Treasury to dump British sterling on the international market, which would depress the value of the British pound. The threat of subsequent inflation and inability to pay for imports was enough to force the British to withdraw their troops from the Suez Canal, and France followed shortly thereafter (Bracken 2007: 689). The primary reason that the U.S. was successful in this implementation of financial warfare was the economic subservience of Great Britain to the United States. Since 1940, Great Britain had been dependent on the U.S. to pay for its military ventures, and furthermore, Great Britain was in a fragile economic position to begin with. Additionally, with the U.S. controlling Great Britain's access to the lending capabilities of the IMF and World Bank, the U.S. was able to exercise full control over the British government, who had no alternative sources of funding (Kunz 1991: 193). Thus, through spending beyond its means, Great Britain put itself in an extremely vulnerable position to the financial prowess of the United States, and in the words of Diane Kunz (1991): "this blindness gave the American government the opportunity to use its economic power to humiliate and defeat Britain in a fashion that Germany in two world wars had not been able to do." (194)

Soon after, the use of financial sanctions began to develop as the U.S. realized its power to block entities' access to credit, either through lending from organizations such as the IMF, or simply through the international financial system. Perhaps the most prominent example of a U.S. sanctions episode is the Iranian Hostage Crisis, as well as the sanctions in the following decades implemented as a result of tensions surrounding the development of nuclear weapons. After the seizure of U.S. hostages in the Tehran embassy by Iranian students in November 1979, President Jimmy Carter ordered all of the Iranian government's bank accounts frozen in the U.S. and the U.K. Since then, the U.S. Treasury has pressured other international banks to stop working with Iranian banks, thus making it more difficult for Iranian entities to access the global financial markets. This has had a negative impact on their ability to send remittance payments to overseas citizens, obtain letters of credit, as well as finance trade. A specific example of this is the crackdown of the U.S. on the Iranian Bank Sedarat, where the U.S. managed to get foreign banks to agree to not do business with this bank, under the threat that if banks were to conduct business with this bank, they would risk being cut off from the U.S. financial system. In this operation of financial sanctions, the U.S. was able to coerce major international banks, including UBS and Credit Suisse of Switzerland, as well as ABN Amro of the Netherlands (Bracken 2007: 690). In a report by the Center on Sanctions and Illicit Finance (2015) on Iran, the goal of the United States in leveraging sanctions against Iran is to target "the range of Iran's nefarious activities", including money laundering, illicit finance for the proliferation of weapons, and supporting terrorism (3). Thus, these financial sanctions are not only implemented with the interests of U.S. national security in mind, but also the integrity of the global financial system (Dubowitz and Fixler 2015: 3).

It was not until after the terrorist attacks that occurred on September 11, 2001 in the United States that financial warfare became a mainstream tool for national security purposes. Until then, the U.S. had been implementing financial warfare to some extent as seen above, but it was still not a prominent weapon of national security, nor did the U.S. government have any offices that primarily focused on it. This all changed after 9/11, when the U.S. realized that it needed to develop more innovative tools to address terrorist organizations, and find ways to thwart their operations. Being caught completely off guard during the 9/11 attacks, the U.S. government began a long series of discussions surrounding how it would ensure that such an episode would never happen again. Previously almost irrelevant to discussions of national security, the Department of the Treasury became a central participant in these discussions. As such, on the morning of September 24, 2001, President George W. Bush announced what would become Executive Order 13224:

> "At 12:01 this morning a major thrust of our war on terrorism began with the stroke of a pen. Today, we have launched a strike on the financial foundation of the global terror network...We will starve the terrorists of

> funding, turn them against each other, root them out of their safe hiding places and bring them to justice...We are putting banks and financial institutions around the world on notice--we will work with their governments, ask them to freeze or block terrorists' ability to access funds in foreign accounts...If you do business with terrorists, if you support or sponsor them, you will not do business with the United States of America." (Zarate 2013: 28)

As financial intelligence began to be developed as a major tool for national security, offices dedicated to the acquisition of financial intelligence and the implementation of financial warfare, such as the Office of Foreign Assets Control (OFAC) in the Treasury, as well as the Financial Crimes Enforcement Network (FinCEN)[3], also in the Treasury, were developed, and thus financial warfare became a predominant national security device in the United States.

As can be seen throughout its history, financial warfare has evolved throughout time with the development of currency systems as well as financial markets. As the global financial system has become more integrated, financial warfare has become an increasingly successful tool. Starting with mostly economic sanctions during Biblical times and in Ancient Greece, financial warfare evolved into counterfeiting operations as currency systems developed, and as the global financial system expanded, with access to money and credit becoming largely contingent upon access to global financial markets, financial warfare took the form of sanctions on lending and access to credit. Today, the United States actively enforces financial sanctions on individuals and organizations listed on OFAC's Specially Designated Nationals (SDN) list. A recent example is the fining of Deutsche Bank for working with Iran and Syria, which was in clear violation of U.S. sanctions laws (Moyer 2015). Thus, it is clear that not only does the U.S. take financial warfare seriously, but as a result financial warfare is an increased presence across the world as the U.S. grows increasingly eager to implement it.

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[3] These offices previously had only been focused on money laundering.

1.2: Existing Literature

Economists have written very little on financial warfare. In academia, financial warfare has primarily been discussed by political scientists, such as Paul Bracken, as well as historians, such as Diane Kunz. Paul Bracken is a professor of political science at Yale University who wrote a piece in *Orbis* in 2007 that gave an overview of financial warfare, and Diane Kunz has taught at Yale University and Columbia University, and wrote *Butter and Guns: America's Cold War Economic Diplomacy* (1997) and *The Economic Diplomacy of the Suez Crisis* (1991), which are both well known and cited frequently in the literature surrounding financial warfare. Sanctions have been heavily discussed in the legal literature, such as *Georgetown Journal of International Law* and *Law & Policy in International Business*, as well as in international affairs journals such as *Foreign Affairs* and *International Studies Review.*

Perhaps the most prominent source of literature surrounding financial statecraft is accounts written by previous government officials, as well as publications by government organizations. Juan C. Zarate published a book called *Treasury's war: The unleashing of a new era of financial warfare* (2013) that goes deeply into the development of financial warfare tools since 9/11 and the major transformations that occurred within the Treasury. Zarate served as the first ever Assistant Secretary of the Treasury for Terrorist Financing and Financial Crimes, and previously served as the Deputy Assistant to the President as well as the Deputy National Security Advisor for Combating Terrorism. Thus, Zarate's firsthand experiences within the federal government, and his role played in the subsequent development of financial warfare after 9/11 provide a lot of critical insight into how financial warfare works and its efficacy. Jimmy Gurulé, who served as the Under Secretary of the Treasury for Terrorism and Financial Intelligence from 2001 to 2003, also wrote a book about financial warfare based on his firsthand experience called *Unfunding Terror: The Legal Response to the Financing of Global Terrorism* (2008). Gurulé's book delves into the mechanics of terrorist financing and how intelligence surrounding terrorist finance became a primary weapon of financial warfare following 9/11 through the lens of law. John Taylor, an economist at Stanford University perhaps best known for the "Taylor rule" of monetary policy, served as the Under Secretary of the Treasury for International Affairs during the first term of the Bush administration, and wrote a book entitled *Global Financial Warriors* (2007), which relays his experiences in developing tools of financial statecraft after the 9/11 attacks, much alike Zarate and Gurulé.

The federal government also has published information surrounding financial warfare. Firstly, the Department of the Treasury issues reports on counterfeiting, including which nations counterfeit dollars to the largest extent, as well as estimates on how many counterfeit dollars are in circulation. The Central Intelligence Agency (CIA) and the Federal Bureau of Investigation (FBI) also declassify cases surrounding financial intelligence, for instance the declassification in 2014 of the CIA report surrounding Operation Bernhard. The Office of Foreign Assets Control in the Department of the Treasury publishes a plethora of information surrounding financial sanctions as well as the Specially Designated Nationals list, which is a financial kiss of death for any individual or organization included on it. Aside from the federal government, many think tanks also publish information surrounding financial warfare, such as the Center for a New American Security, the Foreign Policy Research Institute, Strategic Studies Institute, and the Center on Sanctions and Illicit Finance.

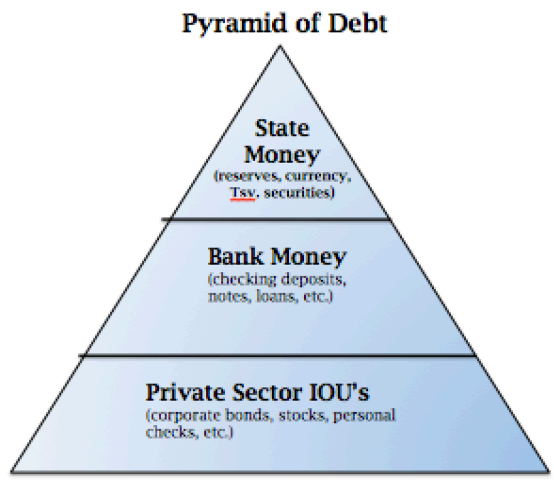
It is thus apparent that the topic of financial warfare has mostly been touched upon from a political, historical, and legal standpoint, while the perspective of economic theory has not entered the conversation to the same extent. In mainstream economics, there has been little theorization on financial markets and monetary hegemony given that according to the mainstream, money is neutral. Because financial warfare encompasses money and financial markets, the void of rigorous economic theory in this discussion is one that certainly needs to be filled in order to better understand the factors that allow a country to successfully implement financial warfare. Hence, this paper turns to the chartalist/institutionalist tradition, where money is non-neutral. Understanding the cruciality of money as a tool of statecraft is essential, as the core theoretical backbone of this project is the chartal/spatialist theory of money, specifically in how it relates to power in the international arena during times of conflict and tension.

1.3: The significance of money

Money plays a major explanatory role in both a country's ability to implement financial warfare, as well as its susceptibility to it. However, before analyzing the applications of monetary theory to financial warfare, discussing the origins of money is necessary. Understanding the origins of money as presented in Chartalism is essential in developing the theory of financial warfare presented in this paper, whose foundation is the idea of money being a creature of the state. As such, there are two major schools of thought surrounding the origins of money: Metallism and Chartalism. In the Metallist school of thought, money was developed within the private sector as a means to minimize transaction costs, and eliminate the need for the double coincidence of wants. As such, the monetary system arises from the use of a good whose identification costs are low and has inherent value, explaining why money is made from precious metals. According to Metallists, the government plays no role in the creation of money, and its involvement in the issuance of money is seen as an impediment to the efficiency of money markets (Tcherneva 2006: 75). Hence, Metallist theory focuses on money as a medium of exchange, and posits that money possesses no special characteristics (Goodhart 1998: 412; Tcherneva (2006): 75, Wray 1998). According to the Metallist view, in the instance of financial warfare, the notion of the efficiency of markets posits that the market will spontaneously find another solution if the money of a country were to be attacked via counterfeiting or sanctions. This is due to the fact that the market spontaneously chooses the medium of exchange. Thus, according to this view, financial warfare would be inconsequential.

Given that Chartalism understands money as a creature of the state, financial warfare as a part of state warfare is better understood via Chartalist theory. Chartalism comes from Friedrich Knapp of the German historical/institutionalist school of thought in economics. Since Knapp's contributions, there has been a revival of chartalist thought in heterodox economics known as neo-Chartalism, or the Modern Money approach, developed by L. Randall Wray. This theory posits that money is a creature of the state, and thus the government plays a central role in its creation and valuation. One of the ways in which money derives its value according to Chartalist theory is through the levying of taxes, whereby the government designates what it will collect the taxes in. Thus, when a government specifies its currency as what it will collect its taxes in, a nationwide demand for money is thus created, as everyone will need money in order to pay their taxes (Goodhart 1998: 416, Wray 1998). The phenomenon of one currency per state is also something that the Metallist theory cannot explain, but is easily explained by the Chartalist theory. The creation of money by a state is therefore not only a means of collecting taxes for a government, but also a way for a government to assert its sovereignty. This goes back to Benjamin Franklin, who believed that not only was the creation of counterfeit continental money by the British an act of war, but the creation of continental money itself was also an act of war. Furthermore, during the Civil War, the creation of confederate money by the seceded states was also an act of war. In both instances, each state was asserting its national independence through the issuance of its own currency, which by definition is a creature of the state.

Fig. 1.3.1

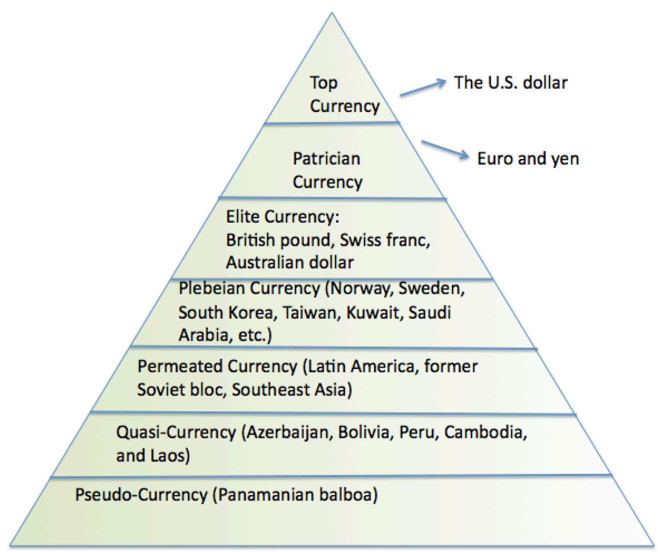


According to Minsky, "everyone can create money, the problem is to get it accepted." (Minsky 1986) As Tcherneva (2006) said, the ability to create debt is not what is important, but instead it is getting someone to hold it (76). Debt becomes money when someone accepts it, and it follows that different monies have different degrees of acceptability (Bell 2001: 151; Minsky 1986; Tcherneva 2006: 76; Wray 1990). This creates a hierarchy of debt that characterizes social debt relationships. As can be seen in Fig. 1.3.1, state money is the most acceptable form of debt (Bell 2001: 158). This is due to the fact that all other economic agents are required to settle their debts through a third party, as is illustrated in the pyramid. However, the state lies at the top because it issues its own liability, and thus does not need to settle its debt through a third party. Given that the state has unlimited access to its own liability, it follows that state money is the most acceptable form of debt, as the state in theory cannot default on its debt. Countries with sovereign currencies have a central bank to guarantee this debt. Hence, we see why money is a creature of the state, as states determine that which is accepted as money through the levying of taxes, and furthermore can always guarantee their debt due to their unlimited access to their liability (Wray 1998).

The state is the ultimate creditor. Hence, given that all debts must ultimately be cleared via state liabilities, it follows that financial warfare, which typically targets the state, permeates to all other levels of the debt pyramid. Furthermore, the implementation of financial warfare on a given country can be perceived as an attack on the its own sovereignty. It therefore comes as no surprise that reactions to financial warfare can be very drastic. For instance, historically the punishment for counterfeiting has been death, and even to this day counterfeiters are still subject to a large fine and extensive jail time.

According to Tcherneva (2016), social stratification and hierarchy are necessary preconditions for the creation of money (4). Hence, while money itself is created out of hierarchy, it follows in turn that money also creates a hierarchy within itself, as different currencies possess different degrees of acceptability within the international arena relative to one another.

Fig. 1.4.1



1.4: "Great powers have great currencies."[4]

Not all money is created equally, and hegemony is relative. The currency pyramid in Fig. 1.4.1 was established by Benjamin Cohen (1998) in his book *The Geography of Money*, and distinguishes between currencies on the basis of competitiveness and influence. The categories that delineate the stratifications on the currency pyramid are top currencies[5], patrician

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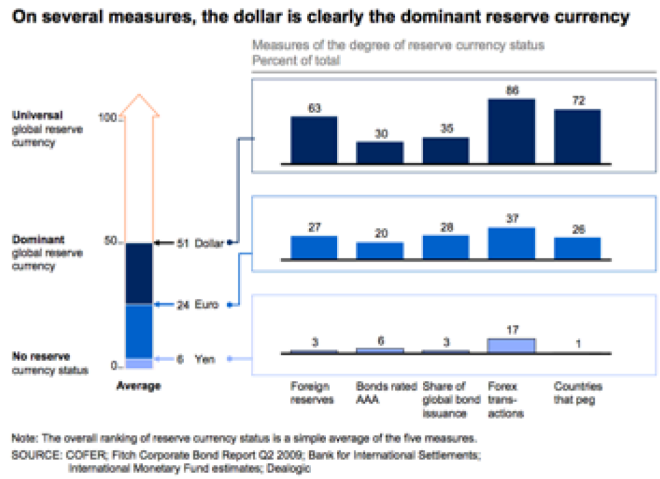
[4] Quote by Nobel laureate Robert Mundell. Source: *Currency and State Power* by Benjamin J. Cohen.

[5] Top currencies are the most widely-used and dominate in cross-border transactions which allows them to not be limited to any particular geographic region. While it is possible for two currencies to occupy this position, such as the dollar and the sterling did during the interwar period, today the dollar is the sole currency occupying this top stratum (see Eichengreen (2005): *Sterling's Past, Dollar's Future: Historical Perspective on Reserve Currency Copmetition*). (Cohen 1998: 116).

currencies[6], elite currencies[7], plebeian currencies[8], permeated currencies[9], quasi-currencies[10], and pseudo-currencies[11]. For currencies towards the top of the pyramid, their influence expands far beyond their legal jurisdiction (Cohen 2003). The U.S. dollar is the sole top currency due to its popularity as well as dominant influence across the world. With money being a creature of the state, the relative dominance of a country's currency is directly related to the power of the country itself; politically as well as economically. This relationship goes both ways, with the strength of a currency being determined by the political and economic strength of its issuing country, as well as the reputation of a country being influenced by the strength of its currency. The currency pyramid is a clear illustration of this phenomenon.

Fig. 1.4.2



Source: Dobbs, R., 2009. An exorbitant privilege? Implications of Reserve Currencies for Competitiveness, s.l.: McKinsey Global Institute.

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[6] Patrician currencies are used in cross border transactions, but their use and popularity is not quite that of a top currency (Cohen 1998: 116).

[7] Elite currencies can be used in cross-border transactions, but typically do not have much influence or popularity outside of their own national borders. The de facto authority of these currencies may extend to a few neighboring countries, but in the international arena they are overshadowed by their more powerful counterparts. As Cohen put it, "Although insulated enough to exercise a fair degree of monetary sovereignty, Elite Currencies lack the clout to control their own destiny." (Cohen 1998: 117)

[8] Plebeian currencies' authority is defined within the confines of their national borders. They are not an international money, and their conditions of operation both at home and in neighboring countries are typically denominated in more powerful foreign currencies (Cohen 1998: 117).

[9] Permeated currencies' authority is even compromised at home. While the government still has nominal currency sovereignty, for some purposes foreign currency supplants the domestic currency. Thus there is a visible functional inferiority with these currencies (Cohen 1998: 118).

[10] Quasi-currencies are not only supplanted as a store of value, but also as a unit of account and medium of exchange as well. These currencies have nominal sovereignty but are typically replaced by other currencies for practical use (Cohen 1998: 118).

[11] Pseudo-currencies exist in name only and have no economic impact (Cohen 1998: 188).

The U.S. dollar is by all measures clearly the universal global reserve currency. About 63 percent of all official foreign exchange reserves are held in dollars, and 86 percent of all foreign exchange transactions involve the dollar. According to the IMF, 66 countries peg or manage their currencies against the dollar (Dobbs et al. 2009: 14). Additionally, oil and most global commodities are priced in dollars. This is illustrated in Figure 1.4.2.

According to Cohen (2011), the monetary power of a country is not only equated with influence, but autonomy as well, or the ability to act freely without constraints imposed by others (5). Furthermore, through balance of payments, all countries are linked together, which threatens their respective abilities to exercise autonomy (Cohen 2011: 5). In the interconnected global financial system and trade, there inevitably is a degree of competition that arises between nations, and a hierarchy develops. It should come as no surprise that the positioning of countries in this hierarchy is essentially the same as the positioning of countries on the currency pyramid. As Cohen (2011) points out, it is not insignificant that in every instance the dominant currency's issuing nation has also been a major, if not dominant, economic as well as political power (9). Thus, there is an inextricable link between financial hegemony and monetary hegemony, especially when a currency is the backbone reserve currency of the entire international economic system.

What makes a country's currency suitable as a reserve currency? These requirements line up with the functions of money in general, and thus a currency that serves as a global reserve currency must fulfill these roles with confidence backed by the issuing country. Firstly, a reserve currency must offer a store of value, making it a safe asset in which to invest official reserves as well as denominate contracts (Dobbs et al. 2014: 14). The relative stability of the value of the U.S. dollar compared to other currencies serves to eliminate uncertainties to some extent in transactions agreements, and thus it makes perfect sense that economic agents will prefer to use it over other currencies as a store of value. A reserve currency must also be an effective medium of exchange, allowing global transactions to occur in an easy and low-cost manner. Lastly, a reserve currency is a unit of account, and therefore is a widely held and recognized currency that can be used to denominate international contracts, such as transactions in commodities such as oil. All three of these functions are interconnected, and are contingent upon the power of the issuing country itself. Given that the United States is the largest economy in the world, with liquid financial markets, it has been the obvious choice for a global reserve currency in the post-World War II period. The geopolitical leadership of the United States since World War II has undoubtedly played a major role in securing its global monetary hegemony (Cohen 2011: 14).

Dobbs et al. (2009) and Cohen (2011) also identify benefits associated with being the issuer of an international money.[12] Macroeconomic flexibility is an important gain derived from monetary hegemony. Not only does the U.S. have a sovereign currency regime, but other countries accept U.S. dollars as an acceptable form of payment due to its strength as a reserve currency. Thus, it is easier for policymakers to pursue public spending objectives, both domestically and internationally (Cohen 2011: 9). This is a major way in which a monetary power exercises its autonomy, and in turn how autonomy leads to more power. In addition to economic gains derived from monetary hegemony, political gains are achieved as well. The first of these gains is reputation, where a position of prominence in the hierarchy of global currencies is typically a reflection of a country's position in international affairs. This is a form a soft power. Hard power is also gained as well. Through prominence in the currency hierarchy, a country's power to exercise leverage over others through its control of financial resources is increased as well. Thus, from monetary power comes influence and geopolitical power (Cohen 2011: 10). This power is inextricably linked with the U.S.'s ability to implement tools of financial statecraft. In order to understand the U.S.'s position as a monetary hegemon, it is important to also understand how it got there.

1.5: The U.S. Dollar's Ascent to Monetary Hegemony

Just a month after D-Day, a conference between forty-four nations was held in Bretton Woods, New Hampshire, whose goal was to essentially restructure the entirety of the global financial system. Starting in July 1944, this process would take about two years before a final consensus was agreed upon.

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[12] One of the benefits of being the issuer of an international money cited in the literature is that of seigniorage. Seigniorage is the profit associated with issuing a currency, or the difference between the production costs of with issuing a currency and the value gained by holding the currency, or its purchasing power. However, Chartalists dismiss the notion of seigniorage, given that according to Chartalist theory, there is no funding constraint in issuing a currency, given that a country can always issue more of it. (see: L. Randall Wray (2003): *Seigniorage or Sovereignty?*)

Prior to World War II, the inter-war world economy was plagued by the effects of the Great Depression, and international trade was largely inhibited by currency blocs and other barriers. Thus, the world, namely the United States and the United Kingdom, saw a dire need for a restructuring of the international financial system. The U.S., in particular, wanted to push for more accessibility to international trade.

The U.S. and the U.K. had made developments toward international free trade prior to the Bretton Woods conference in 1941 when they signed the Atlantic Charter. The Atlantic Charter guaranteed equal access to trade through security measures such as freedom of the seas, as well as granting access to raw materials (U.S. Department of State). However, other measures needed to be taken in order to ensure that free trade would exist. One of the most important measures was to create a system in which currencies could be easily converted between one another. Prior to Bretton Woods, international currencies were backed by gold. However, with no central regulatory body, countries began to skirt the restrictions imposed on their currencies by the restraints on the supply of gold, and thus the value of international currencies became unstable, and thwarted international trade. At Bretton Woods, countries agreed that they did not want to revert back to this and had to figure out a system in which all currencies could be backed by one asset, and a central regulatory body that would maintain the values of these currencies with respect to this asset.

As stated earlier, the U.S. and the U.K. were the two key players in the Bretton Woods Conference. As such, the two major plans came from the U.S. and the U.K. From the U.S., a plan was proposed by a senior Treasury official named Harry Dexter White, and from the U.K., a plan was proposed by a British economist named John Meynard Keynes. While White was primarily concerned with price stability, Keynes was mostly concerned with economic growth. Keynes had the more radical plan, proposing the creation of an international central bank that would supply an international currency, as well as act as a lender of last resort, ensuring stability in the global financial system. He suggested that this currency be called the *bancor*. However, what Keynes failed to take into account was that a central bank has a larger role than just supplying money and acting as a lender of last resort. An international central bank would have no political power to influence national policies to ensure that countries would not take advantage of the central bank's lender of last resort function, which should only be used sparingly (Wachtel 2007: 7).

White proposed the creation of an international organization who would not issue its own currency, but instead have lending abilities that come from its member institutions. Whether it was due to the geopolitical power of the United States after World War II, or the more pragmatic nature of White's proposal as opposed to Keynes', it was White's plan that was adopted, leading to the creation of the International Monetary Fund (IMF). The IMF was structured by White's plan, but developed along the Keynesian view of promoting economic growth and government intervention to ensure stability, growth, and employment levels (Watchel 2007: 8). The IMF would lend to countries with balance of payments issues, and maintain the exchange rates of international currencies. However, the structure of the IMF itself ensured a significant degree of U.S. power. Member institutions would vote to allow countries to change their exchange rates as well as on whether or not to extend credit to countries with balance of payments problems. This voting system was not a one-to-one system, but instead voting power was based on a quota system the reflected each country's relative power. The U.S., being the most powerful member nation, had the strongest vote, holding about one-third of all IMF votes. This was enough to allow the U.S. to single-handedly veto any changes to the IMF charter (Leech 2002: 26).

In addition to the establishment of the IMF, as well as other international organizations such as the World Bank, Bretton Woods also established the pegged rate currency regime. The nations at the Bretton Woods conference had to come up with a currency system in which currencies could peg their values with respect to one asset, establishing more stability in the international financial system as well as easing the flow of international trade. Gold was no longer a suitable choice, as there was not a sufficient supply of gold to meet the increasing demands of an expanding international financial system. The British pound, once a suitable reserve currency, was not a strong choice either given the fragility of the post-World War II British economy. Thus, the United States dollar emerged as the obvious choice. It was decided that the U.S. would fix the value of the dollar with respect to gold at $35 per ounce (Eichengreen 2004: 7). The dollar would be the only currency fixed to gold, and all other currencies would instead peg their values with respect to the U.S. dollar, at a parity of plus or minus 1 percent. If countries wanted to change their exchange rate with respect to the dollar by 10 percent or more, they would have to obtain approval from the IMF, or otherwise be denied access to IMF lending. Countries would therefore buy and sell U.S. dollars on the international market to maintain parity.

To further secure the U.S. dollar's strength and presence in the international financial system, the U.S. also lent to a great extent to other countries during the post-World War II period. In March 1947, the U.S. passed the Truman Doctrine, in which it lent about $400 million in emergency assistance to states, such as the Greek and Turkish regimes, that were at risk of a communist revolution (U.S. Department of State). The benefits to the U.S of the Truman Doctrine were twofold: it aided in securing U.S. dollar hegemony as well as in combating communism. A few months later in June 1947, Congress passed the Marshall Plan, where the U.S. lent about $13 billion in total to the weakened post-World War II European economies in the form of grants, rather than loans (U.S. Department of State). By the 1960's the U.S. had went from running a current account surplus to a current account deficit, as it took on its responsibility of providing the world with liquidity (Eichengreen 2004: 13). The U.S. dollar likely would not be able to successfully be a reserve currency if the U.S. ran a current account surplus, as U.S. dollars need to be readily available to foreign nations, rather than sitting in the U.S. Both the Truman Doctrine and the Marshall plan were significant in establishing a large outflow of U.S. dollars into the global financial system, as well as in establishing the U.S. dollar as the backbone currency for the world.

The Bretton Woods system and the post-World War II lending by the U.S. effectively established the U.S. dollar as the dominant reserve currency. The U.S. dollar became the only currency that was backed by gold, and came to have the highest purchasing power. Even when the system collapsed in 1971, and the U.S. dollar ceased to be backed by gold, the U.S. dollar's strength as a reserve currency was perhaps increased. Eichengreen (2004) states that after 1971, the pegged currency system went from a gold-dollar standard to simply a dollar standard (9). Since then, the U.S. dollar has essentially maintained its dominance as the global reserve currency. In the original Bretton Woods system, a core consisting of the United States was established along a periphery consisting of Europe and Japan. The role of the core is to issue the dominant currency, where the role of the periphery is to expand through export-led growth, effectively exposing them to U.S. dollars. Today, the U.S. still remains at the core, and the periphery is now Asia. A third bloc has been created consisting of Europe (Eichengreen 2004: 1). Some argue that the euro is a strong contender for a global reserve currency, however it is likely that if the euro even stands a chance at becoming the global reserve currency, there are still many issues that need to be worked out within the structure of the European Monetary Union before this is even a remote possibility. Being a member of the core versus a member of the periphery has more implications than just those related to currency and economic growth; there are also legal considerations as well, which would have a major impact during times of crisis. These legal factors would serve to enhance the hegemonic position of core, or apex, countries.

1.6: Law and Finance

Before introducing the theory of financial warfare, discussing the interconnectedness of law and finance is in order, as this relationship is a key component of the theory of financial warfare introduced by this paper.

Firstly, without law, the complex global financial system that we have today would not be able to exist. Financial assets are by nature legally constructed, as any financial debt obligation is backed by some sort of contract constructed in some cases with the direct intervention of lawyers, and otherwise is backed by some legal constraints. Furthermore, money itself is legal tender, and thus is a legal debt obligation by the state. Law is also used to address the uncertainty of financial markets, however sometimes it can also contribute to the inherent instability of financial markets, if contracts are established on unstable or bad premises.

Through the hierarchies of debt and currencies described above, a financial hierarchy exists as well. Because at the top of the debt pyramid lies state-issued debt, or state money, and a country's position on the currency pyramid reflects the strength of its currency, it can be concluded that the strength of a currency relative to others is a direct reflection of the sovereign power of that country. The financial hierarchy is organized in the same way, with the more politically and economically powerful countries at the top, and the weaker ones at the bottom. One's position in the financial hierarchy has major implications for not only its power in world affairs, but its treatment during times of crisis as well (Pistor 2013: 1).

According to Pistor (2013), elasticity of law can be defined as the probability that ex ante legal commitments will be relaxed or suspended in the future (16). In general, empirical observation has shown that countries at the apex experience a higher elasticity of law than do countries at the periphery. The primary reason for this is that elasticity is essential for the survival of the global financial system, and the survival of the global financial system is primarily contingent upon the condition of the countries at the apex. Thus, during times of crisis, apex countries experience more flexibility, while countries at the periphery do not, due to the fact that adherence to the legal structure of the global financial system is what allows periphery countries to have access to it in the first place. Times of crisis therefore have the greatest negative impact on periphery countries (Pistor 2013: 33).

Another major reason that countries at the apex experience a higher elasticity of law is power. As Pistor (2013) states, “Where law is elastic power becomes salient.” (29) Countries that issue their own sovereign currency that lands high in the hierarchy of currency possess macroeconomic flexibility, and thus have the power to finance public spending, which is essential during times of crisis. Periphery countries that issue their own sovereign currency, but have to borrow in another currency due to the fact that their currency is not deemed strong by the international currency hierarchy do not have this power, just as countries under strict currency boards do not either. Countries in currency unions such as the European Union also do not have this power. Additionally, in order for contracts to be agreed upon, the backing of the contract has to be denominated in a legal tender that the parties involved are confident will be a stable form of payment. Thus, the characteristics of such a currency is that it must be issued by a state that has unlimited access to its own high powered money, and therefore must have a sovereign monetary regime. Based on where it falls in the hierarchy of currency and the fact that it has its own central bank that in theory can issue unlimited amounts of its own currency, this puts the United States at a major position of power in the global financial system. The United States Federal Reserve is therefore one of the most powerful individual entities in the global financial system, since it is the body that issues the backbone reserve currency in which contracts are denominated, transactions conducted, and most countries accept as a form of payment.

1.7: A Theory of Financial Warfare

From understanding the chartalist theory of the origins of money, and the hierarchal nature of money, currency, and the financial system, a theory surrounding the ability of a country to successfully implement financial warfare can be developed. The argument presented in this paper through the presentation of case studies and pre-existing economic theories as support will claim that there are certain pre-conditions for a country to be able to successfully implement financial warfare, and thus not every country is able to successfully implement it. Going further on that line of argument, it may be true that given its position as a financial hegemon, the United States may be the the most powerful state in the realm of financial warfare.

Stemming from the chartalist theory, money can be analyzed as an instrument of conflict. Through the claim that money would not exist without social stratification and hierarchy, the chartalist view highlights that the condition of hegemony is relative. Under a hierarchal system consisting of creditors and debtors, characterized by non-reciprocal debt obligations imposed on a population by a ruler or central authority, it becomes clear that the process of the creation of money itself is indeed a process of power. The notion of money as a vehicle through which a ruler establishes their power over their people is nothing new. However, the influence of a money need not be restrained to its national borders, as we have seen in Cohen's *Geography of Money*, which asserts that the spatiality of a powerful money transcends national borders, and hence a powerful sovereign money has influence beyond the legal jurisdiction of its issuing sovereign. What determines whether or not a money is powerful? As Minsky said, anyone can create money, the problem is getting it accepted. Hence, how money is accepted is a reflection of the entity issuing it. The more powerful and stable the issuing sovereign is, the greater the influence their money has, and hence the greater the expanse of their monetary space. Money has been an instrument of colonization, as we have seen in Africa[13], an instrument of expanding economic influence, such as the Truman Doctrine and the Marshall Plan, an instrument of attack, such as in counterfeiting and terrorist finance, and an instrument of punishment, as we have seen in sanctions. Focusing specifically on money as an instrument of tension and conflict from the perspective of the chartal spatialist approach to money, this project seeks to simultaneously add to the chartalism conversation and better understand warfare, the ultimate culmination of tension and the struggle for power, in its financial implementation.

Similar to how a country cannot be successful in traditional warfare if it does not have a strong military, a country cannot successfully implement financial warfare unless it holds a strong position within the global financial system. With the U.S. dollar being the backbone currency of the world, and thus the Federal Reserve being arguably the most powerful institution in the global financial system as a result, the United States is *the* global financial hegemon. It has unlimited access to the most powerful currency in the world, and is also arguably the most powerful nation in the world from a political standpoint as well. Given its power in the global financial system, the Federal Reserve is able to determine who sinks or floats in financial markets, especially during times of crisis.

This financial power is what allows the United States to be successful in its implementation of financial warfare. The United States can strangle a state or terrorist organization financially just simply by denying it access to U.S. dollars. For instance, in July 2015 the Federal Reserve stopped sending U.S. reserves to Iraq due to intelligence that revealed that some of the U.S. reserves coming into Iraq were making their way into the hands of Iran and the Islamic State of Iraq and Syria (ISIS). Established in 2004, the Central Bank of Iraq primarily uses the U.S. dollar, and therefore requests dollars from the Federal Reserve Bank of New York as they are needed. However, U.S. officials found out that the dollars arriving in Baghdad had made their way to three sanctioned Iranian banks--Islamic Regional Cooperation Bank, Bank Melli, and Parsian Bank, and it is illegal for the Federal Reserve to knowingly send dollars to these sanctioned institutions. Thus, the U.S. stopped the flow of dollars into Iraq until they could tighten their regulations to the extent that would make the U.S. confident that the dollars were not falling into the

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[13] See: Tcherneva, P (2016). Money, Power, and Monetary Regimes (Working Paper No. 861). Levy Economics Institute: pg 8.

wrong hands. Iraq was quick to tighten its regulations, and was once again granted access to U.S. dollars that August (The Tower 2015).

Because all financial contracts need to be backed by a strong legal tender, and the U.S. dollar is the dominant global reserve currency, making the Federal Reserve the ultimate backing institution, it can severely cripple the operations of any country or terrorist organization if their access to U.S. dollars is cut off. Furthermore, given the U.S.'s strong influence in the global financial system, it also has the ability to cut sanctioned entities from the global financial system completely. Countries with less powerful currencies, especially countries that do not have a sovereign currency, such as the members of the European Union, do not have the ability to wield this sort of power over international entities. Furthermore, if countries were to try the same tactic with the United States, they would not be nearly as effective. For instance, if the Japanese were to cut off the United States from the yen, it would face the much more dire threat of being cut off from U.S. dollars in return, which would have much more destructive consequences for them. Thus, not only are other countries unable to implement financial warfare to the extent that the U.S. can, they also cannot use it against the U.S. unless they are willing to face the risk of financial retaliation by the global financial hegemon.

The United States' position as an apex country only further serves to enforce their position as a global hegemon. Apex countries have the most elastic relationship with the law, and therefore this also allows the United States to exercise a good deal of power in its implementation of financial warfare. Given the power that comes from being the apex country in the global financial system, the U.S. has been able to develop financial warfare tools that no other country likely could. For instance, the Society for Worldwide Interbank Financial Telecommunication (SWIFT), is a financial messaging service for financial transactions communicated between member banks. SWIFT is well-known to the world's bankers, and it is used daily by thousands of banking institutions around the world. According to Zarate (2013), SWIFT forms the communication backbone of the formal financial system. Prior to 9/11, the Treasury did not have access to SWIFT because SWIFT is a private institution that is supposed to remain politically impartial. However, after 9/11, the U.S. government wanted access to its treasure trove of financial intelligence. SWIFT data reveals which banks were involved in which transactions, as well as specific information about the banks, accountholders, amounts transferred, dates and times of transactions and transfers, and contact information. With this data, the U.S. could have access to financial intelligence unparalleled by any other country, and be able to discover and thwart plots that threaten national security faster than ever (Zarate 2013: 50). While the U.S. had previously been rejected by SWIFT for access to its data, this time the U.S. really wanted it. Thus, the Treasury lawyers that went into negotiations with SWIFT, David Aufhauser and Paul O'Neill, were set on the fact that not only would the Treasury get access to SWIFT, but that the Treasury would have control over this relationship. Walking into the meeting with Leonard Schrank, CEO of SWIFT, Aufhauser boldly stated "I want your data." At the end of the meeting, an agreement was made that the Treasury would have access to SWIFT's data, and thus the U.S. had exclusive access to this huge database of private financial information (Zarate 2013: 52-53).

It is hard to make the case that any other country could have achieved this. While Zarate (2013) claims that part of Schrank's decision to allow the U.S. access to SWIFT's data was due to his identification as an American, it likely had more to do with the powerful financial and political position of the U.S. in the world (52). If Schrank were German, it is doubtful that he would have granted Germany access to SWIFT data if they had come knocking on his door. Thus, this elastic relationship that the U.S. has with rules is something that allows it to implement financial warfare in way that no other country could at this point in time.

Thus, this theory of financial warfare is that not every country can successfully implement it. In order to successfully implement financial warfare, a country has to be in a position of higher financial power than the country it is targeting. In this sense, financial power means that a country has a strong sovereign currency, allowing it to have little restriction in monetary and fiscal policy. A country also must have a somewhat elastic relationship with the law, allowing it flexibility to do what it takes to maintain financial prominence during a crisis, and also to exercise its power in innovative ways that its target country cannot. Thus, emerging economies on the periphery are likely not strong candidates for implementing financial warfare. Also, given the position of the United States as the global financial hegemon, with the U.S. dollar being the backbone reserve currency for the entire global financial market, the power of the Federal Reserve as a backing institution for financial activity, the geopolitical power of the U.S. government, and the elastic relationship the U.S. has with rules, this theory of financial warfare can be taken further to say that no other country at this point in time can implement financial warfare with as much success as the United States. Thus, no country can implement financial warfare against the U.S. successfully, and when the U.S. targets a country in its implementation of financial warfare, that country cannot successfully retaliate. Prior to World War II, the U.S. imposed sanctions on Japan and froze its assets. A week before the attack on Pearl Harbor, the Japanese ambassador said,

> "The Japanese people believe that economic measures are a more effective weapon of war than military measures...They are being placed under severe pressure by the United States to yield to the American position; and [they believe] that it is preferable to fight rather than yield to pressure." (Zarate 2013: 5)

Since 9/11 this has only become more true, as the U.S. has focused to a greater extent than ever on developing its ability to use financial warfare. In the recent campaign against North Korea, the U.S. implemented financial pressure unlike the North Korean regime had seen from any other international sanctions. For the first time, North Korea was concerned that its bank accounts and illicit financial activities were in real jeopardy. As a result, a North Korean deputy negotiator quietly admitted to a senior White House official, "You finally found a way to hurt us." (Zarate 2013: *x*)

As such, this paper on financial warfare inevitably becomes a paper about money as an instrument of conflict and tension. It employs historical, institutionalist, and legal perspectives in addition to the chartal spatialist notion of money to understand the hierarchy of money in the international arena, and how that affects money as an instrument of conflict and tension. The following chapters on counterfeiting, sanctions policy, and terrorist finance, all methods of financial warfare, each tell an important piece of the story. Through analyzing counterfeiting, we can evaluate financial warfare as an attack on the sovereign. Hence, the questions of how sovereignty is recognized, as well as how it is enforced and/or challenged through money are examined can be examined through the uses of counterfeiting as an act of financial war. Sanctions policy illustrates the extension of the sovereign onto subsidiary entities. Through understanding the salience of sanctions policy, the mechanics behind how a powerful money's influence can extend beyond its legal jurisdiction become apparent. Lastly, terrorist finance provides a more specific example of sanctions policy, but what makes it important is that thwarting terrorist finance is what brought financial warfare to the forefront of national security policy. Counter-terrorist finance sanctions policies are not only implemented on countries, but individuals and organizations as well. Given the underground nature of terrorist finance, the United States had to employ its hegemonic power as discussed in the previous chapters, exercising power in innovative ways that only a country of its hegemonic position could do. Exploring the counterterrorism efforts after 9/11 in the United States solidify the factors that determine the U.S.'s powerful stance in the financial war arena: a powerful currency that expands beyond its legal jurisdiction, flexible access to the law, and its position as the central authority in the international financial system.

Ch. 2 - A Systematic Analysis of Counterfeiting

"The destiny of a currency is, and always will be, the destiny of a nation."
- Franz Pick

The work of numismatists has shown that counterfeiting has existed since the first coins were produced in Lydia in the 7th century BCE. The popular methods included clipping, shaving off, or melting the coins, and each offense was punishable by death (Tcherneva 2016: 10). In the United States, while the death penalty is no longer the punishment for counterfeiting today, entities caught counterfeiting still face what is essentially a financial death through ostracization via designation and imposed sanctions by the U.S. Treasury. Throughout history, counterfeiting has been treated as a serious offense, as the act of counterfeiting not only holds negative implications for the economic health of a country, but that country's political hegemony as well. The confidence and stability associated with a given currency is reflective of the country who issues it, and therefore in forging a currency, one is essentially attacking a country, threatening its sovereignty.

This chapter will be examining the interlinkage between a currency and it's issuing country's sovereignty, particularly in how it applies to the instance of counterfeiting. As such, the subsequent theoretical exploration of this subject will posit that the relationship between counterfeiting and sovereignty is twofold: in counterfeiting a country's currency, an entity is either threatening a country's sovereignty in an act of war, or, perhaps simultaneously, succumbing to the sovereignty of a country. Printing forged notes could be necessary for a country who needs to service its debt in a stronger currency, or purchase goods. Either way, the notion of sovereignty underlies the motives behind counterfeiting, and as such, such an examination could be very beneficial.

2.1: Prior Theoretical Treatment of Counterfeiting

Not a significant amount of work, especially in the field of economics, has been conducted on counterfeiting from a theoretical standpoint. There are likely a number of reasons for this; perhaps counterfeiting does not fit neatly in conventional models, or, from the standpoint of empirical analysis, the availability of data on counterfeiting is quite limited, given the underground nature of counterfeiting.

However, despite this deficiency in the existing literature, there have been some studies of counterfeiting from a game theoretic perspective as well as other types of analyses, demonstrating that some type of dialogue has been started.

Fung and Shao (2011) divide the existing literature into two theoretical categories: partial equilibrium and general equilibrium models. In the partial equilibrium models, the demand for money is assumed to be exogenous and does not depend on the actions of agents in the model (Fung and Shao 2011: 31). Lengwiler (1996) takes a game theoretic approach to counterfeiting, with the central bank and counterfeiters as players in a pure-strategy subgame-perfect equilibrium. Depending on the parameter values, namely the face value of the notes themselves, the central bank either chooses a very secure design where counterfeiting would be too costly relative to its returns therefore leading to no counterfeiting, or the central bank choses a design that is not very secure, and therefore counterfeiting exists at equilibrium. Lengwiler states that there are no intermediate cases in equilibrium, meaning that either counterfeiting occurs alongside notes produced without many security measures, or counterfeiting does not occur due to highly secure notes. According to his model, he finds that the central bank behaves discontinuously. If the face value of the note is high enough, the central bank chooses a high level of security, just enough to make counterfeiting unprofitable. If the face value of the note is lower, the central bank chooses to design its notes with less security measures, making counterfeiting relatively easy. Therefore, Lengwiler concludes that countries that use highly denominated bank notes also use an expensive design for their notes, making them difficult to counterfeit, while countries that use low denominations of their notes use easy to counterfeit, cheap notes. Lengwiler brings up the example of the relative security levels of U.S. dollars and Swiss francs. Swiss francs are worth between 10 and 1000 francs (about $7 to $700), while American dollar bills are worth between $1 and $100. As such, American dollar bills have only slightly been altered during the past few decades (with the exception of the $100 bill) and are considered easy to counterfeit, while Swiss francs are considered to be amongst the most difficult to counterfeit (Lengwiler 1996: 123, 124, 129, 130, 131). Empirical support for Lengwiler's findings is mixed. For instance, in the United States, while the $20 note is the most widely counterfeited note domestically, the $100 note is the most counterfeited U.S. note internationally, despite the high security measures, as is illustrated in Fig. 2.1.1 (U.S. Treasury Dept. 2003: 51).

Figure 2.1.1: Counterfeiting of U.S. Notes by Denomination

Counterfeiting Rates in Deposits at Federal Reserve Banks, 2002

Denomination	Total notes processed (millions)	Value of counterfeits detected (millions of dollars)	Counterfeits detected per million notes processed
$1	11,931.0	0.01	0.7
$2	18.1	0.00	1.1
$5	2,421.5	0.05	4.2
$10	2,196.7	0.25	11.6
$20	14,804.5	1.39	4.7
$50	1,209.3	0.31	5.1
$100	1627.0	5.00	30.7
Total	**34,208.1**	**7.01**	**5.0**

Source: U.S. Treasury Dept., Federal Reserve, and the Secret Service

Quercioli and Smith (2009) also use a partial equilibrium approach to examine the strategic interaction between merchants and counterfeiters in a model environment where counterfeiters select the quality of counterfeit notes to produce and merchants verify the notes offered to avoid accepting forged notes. Like Lengwiler, Quercioli and Smith find that the behavior of merchants and counterfeiters varies with note denomination. Their model has three distinct implications: there is no counterfeiting of low denominations due to the fact that the expected gain is not large enough to cover the cost of production, merchants choose to exert more effort when verifying high denomination notes because the losses from accepting counterfeits are larger, and the counterfeiting rate, measured as a fraction of counterfeit notes to the total notes in circulation, displays a hump-shaped distribution across denominations (Fung and Shao 2011: 32). Again, empirical evidence, as shown in Fig. 2.1.1, indicates that this last conclusion may not be correct in reality.

In general equilibrium models, the mechanisms within the model that generate money as the medium of exchange are explicitly specified, and the demand for money is dependent upon the interactions of agents in the model (Fung and Shao 2011: 32-33). Kultti (1996) uses a search-theoretic approach to the creation of money which concludes that counterfeit money will not circulate in two instances: when the punishment for counterfeiting is too severe, or if people are patient, meaning that they will wait until they get genuine money. However, counterfeit money is accepted when the punishment for holding it is not too severe, and when there is not a sufficient amount of money in circulation (Kultti 1996: 183, 185). Kultti's model is built upon the notion that there are situations in which counterfeiting money increases the efficiency of trade, and thus counterfeiting can potentially have societal benefits.

Thus, Kultti claims that rulers in these instances may ease up on punishments to counterfeiting. However, this paper does not acknowledge the fact that as the sole issuer of currency, a sovereign state has more control over issues of efficiency and economic contraction due to a shortage in the money supply than just simply having the ability to adjust the punishment for counterfeiting. In other words, in these situations, the counterfeiting of money in the private sector is not the only option in these situations, in fact it is the less attractive option, given that counterfeit notes are not backed by the assets and authority of any figure or organization. Hence, this is likely why we see the punishment for counterfeiting remaining fairly consistent in severity throughout time.

Monnet (2005) examines counterfeiting from a social perspective, assessing the implications on social welfare of the decision to counterfeit. This paper argues that genuine notes are less costly to produce than counterfeit notes because of factors such as economies of scale. Thus as the cost of counterfeiting increases, there are less forged notes circulating in equilibrium. Because higher costs of counterfeiting discourage the creation of forged notes, these higher costs are associated with higher social welfare, as investment would therefore not be directed at counterproductive activities such as counterfeiting. To add to the argument that higher costs of counterfeiting result in higher social welfare, counterfeiting can also lead to inflation, given that it results in a perceived increase in the money stock (Monnet 2005: 19). Friedman (1960) also argued that counterfeiting can have a large social cost (Fung and Shao 2011: 33). Monnet concludes by saying that a lax anti-counterfeiting policy is therefore inconsistent with price stability and the goal of social welfare (Monnet 2005: 19). Li and Rocheteau (2011) also argue that counterfeiting lowers the volume of transactions, due to the fact that sellers are concerned about receiving counterfeits, which would be mitigated if stronger anti-counterfeiting policies were implemented (Fung and Shao 2011: 34). Nosal and Wallace (2007) similarly argue that the threat of counterfeiting alone can have a significant negative impact on the economy, as people may not accept money as a mean of exchange due to a lack of confidence in the currency due to counterfeiting (1001). Furthermore, counterfeiting also imparts costs onto society through the costs associated with producing more secure notes, providing proper law enforcement, and the loss of confidence in bank notes (Fung and Shao 2011: 34).

While this limited collection of literature on counterfeiting provides interesting insights, its rigor from the perspective of monetary economics as well as international economics is lacking. Fung and Shao (2011) point out one critique of the existing literature, namely occurring in the general equilibrium models, where counterfeiting is defined as the private provision of money. However, in reality society does not consider counterfeiting as the private provision of money for two major reasons. Firstly, legitimate money is produced by private banking institutions, who are not only reputable, but also have assets to back the money that they issue. Furthermore, the appearance of this money is distinctive from that of state-issued money, so that no mistake could be made in confusing one for the other. In counterfeiting, however, forged notes are produced with the intent of passing as state-issued currency. There are no assets backing these notes, and if they are recognized as counterfeit, they will not be accepted as a means of payment. Fung and Shao go on to make an interesting and problematic point, wherein assuming that counterfeit money can only last for one period before being confiscated, they claim that counterfeit money therefore has no value because it cannot serve as a medium of exchange (33). More caution should be exercised in the use of the world "value". What do they mean by value? It can be argued that a note, forged or genuine, has value if it is accepted as a medium of exchange in transactions. Therefore, while a counterfeit note may not hold value in the sense that it is not backed by the assets of any issuing authority, it may hold value in a more subjective sense in the private sector if it is accepted as a medium of exchange. This draws upon the Minskian notion of the ability of anyone to create money, with the problem lying in getting it accepted. While Fung and Shao's claim holds under the stated assumption of a counterfeit note being in circulation for only one period, in practice the validity of this assumption can be questioned as well as its subsequent claim concerning the value of counterfeit notes.

In addition, there is not much in the existing literature that discusses counterfeiting in the context of international conflict. Not only do rogue individuals within a country counterfeit, countries also counterfeit each other's currency during times of war or conflict. Analyzing counterfeiting as an act of war sheds light on the ways in which countries use money in acts of foreign aggression, and the relationship between a currency and the sovereign. Counterfeiting is more than just a game between players seeking the highest payoff, it is also a monetary phenomena, and without an understanding of the interaction of the monetary and geopolitical forces at play, counterfeiting as an act of foreign aggression cannot be fully comprehended.

2.2: Attacking the Sovereign

Tcherneva (2016) writes, “A history of counterfeiting, as well as that of independence from colonial and economic rule is another way of telling the history of ‘money as a creature of the state’.” (1) The ideas associated with the creation of legitimate, state-issued currency can be applied to understand the act of counterfeiting in acts of foreign aggression. Different monies have different degrees of acceptability, and state money lies at the top of the debt hierarchy, possessing the highest degree of acceptability. This is due to the state’s unique position as the only agent capable of issuing its own liability. As Nussbaum wrote in *Money in the Law* (1950),

> “The question of the extent to which a creditor is under a duty to take "legal tender" in payment is undoubtedly one of private law. The endowment of coins or notes with the character of legal tender is, however, an act of sovereignty, hence of public law.” (Mundell 1998)

Essentially, people are not obligated to accept state money, but they always will. This comes from the state’s ability to declare what form taxes should be paid in, and because everyone needs to pay taxes, there is always demand for state money (Tcherneva 2006: 76-77). Thus, money is a creature of the state, and the ability to issue currency is a characteristic of the sovereign.

This chartalist notion of the creation of money spans through history, even back to Ancient Rome, where the Roman politician Cicero held that *argentum* (in French “argent”, or silver) meant money and not metal. Ancient societies saw money as a creature of the law, and in turn the state. The Greek name for money, *nomos*, and its Roman name *nummus*, which both mean “the Law”, or “that which is created by the law” is indicative that these societies understood that money obtained its value through the authority of the law, not the material with which it was made. Thus, the value of money itself has often far exceeded the inherent value of the material it is made of, such as the leather issues of Frederick Barbarossa, the tin issues of Dionysius of Syracuse, and the gun issues of the Sultan Othman (AD 1259-1326) during the wars against Persia (Mundell 1998). This is also seen in today’s fiat money.

Therefore, the power of a currency in the international arena is contingent upon the geopolitical power of its issuing authority. As Goodhart (1998) said,

> "...the use of currency was based essentially on the *power* of the issuing authority--i.e., that currency becomes money primarily because the coins (or monetary instruments more widely) are struck with the insignia of sovereignty, and not so much because they happen to be made of gold, silver, and copper, (or later paper)." (408)

In counterfeiting a nation's currency, a product of its sovereignty, an agent is therefore undermining the sovereignty of that nation. Not only is there potential for destabilizing a country's economy when one counterfeits their currency, but the bigger element at hand is power. For instance, when North Korea was producing the supernotes in the mid-2000's, the economic impact was slim to none, however the U.S. government was still outraged. As Mihm (2006) wrote in a New York Times article, the economic threat to the U.S. of counterfeiting is minimal, however there is an emotional component. American government officials view the violation of their nation's currency as "a matter of national honor".

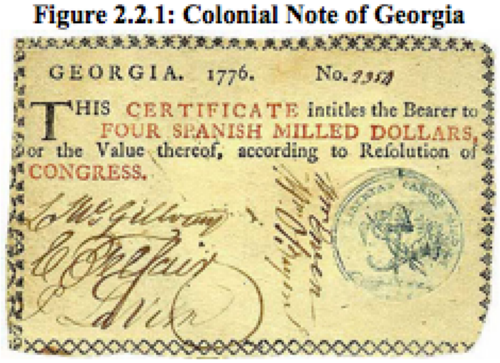
There is a historic case dating back to the reign of Emperor Nero in ancient Rome (AD 54-68) that on the surface seems to support the Metallist claim that money derives value from its metal content rather than from the backing of the sovereign. Throughout Nero's reign, his ego grew and he became increasingly hostile. He fired his freedman financial secretary Pallas, who may have dared to object to Nero's new policy of progressively removing the silver content of Roman coins. At the time, the Roman economy was already experiencing inflation, and Nero claimed that his actions were going to preserve the Roman money. Dubbing his actions as a "currency reform", he began to add copper alloy to Rome's silver denarius coins. The acid on the fingers of the handlers corroded the copper, wearing on the coin and causing the surface to slough off gradually, further reducing the silver content. The alloy continued to be added to the coins as a greater proportion of the coin makeup, until the once trusted silver and gold coins were eventually minted with less than 1 percent silver. As a result, people began to hoard the older coins with the higher metal content, given that their intrinsic value was higher than that of the newer coins made of the copper alloy of the same denomination. As an increasing amount of people stashed away these older coins, the amount of coins in circulation decreased, necessitating the additional printing of the new coins to keep trade and everyday exchange flowing (Cooley 2008: 59). This is characterized by

Gresham's Law, which states that "bad money" drives out "good money", or in other words, if a new money enters circulation (bad money, i.e. counterfeit), and there is an old money that is still in circulation (good money, or higher metallic content in this context), people will hoard the good money, and in doing so leave the bad money in circulation until there is no more good money left in circulation.

While this may seem like a strong argument for Metallism, a little more insight may prove differently. Emperor Nero was not a sound ruler--he eventually slashed all relationships with those near to him, such as his wife Octavia, who he deserted for a commoner named Acte, then for Poppaea Sabina, the wife of his friend Otho. In AD 59 he murdered his mother, Agrippina. Nero subsequently divorced, exiled, and murdered Octavia, and then married Poppaea (Cooley 2008: 58-59). As the Roman empire was in decline, a once robust economy where counterfeiting was punished with death became one where counterfeiting was common, given that even the emperors themselves were involved. What Emperor Nero was doing to Rome's currency can be characterized as a form of counterfeiting, wherein acting under the guise of currency reform, he was actually intentionally further destabilizing Rome's currency, and by extension, Roman society. In other words, as the power of the sovereign was declining, the currency itself was declining with it. Additionally, as the sovereign power of the Roman Empire faltered, the older coins of pure metallic content converted into physical assets, and were therefore held for their gold/silver market value, rather than their money market value. As Chartalist theory states, the power of a sovereign nation is contingent upon the power of its currency.

Another historical instance evidencing the fact that sovereignty and money are interconnected is the monetary situation in the American colonies prior to the American Revolution. Each colony issued its own currency note, denominated in either British pounds or Spanish milled dollars. Thus, the issuing authority behind the notes was not derived by the colonies themselves, as they were not a sovereign entity capable of issuing their own currency due to their subordinace to the British Empire. Instead, the colonies appealed to the sovereign issuing authorities of

Figure 2.2.1: Colonial Note of Georgia



Source: Federal Reserve Bank of San Francisco

Figure 2.2.2: Colonial Note of Pennsylvania

Source: Federal Reserve Bank of San Francisco

Great Britain and Spain through their currencies. Thus, colonists using colonial money would have confidence in these notes because their value was guaranteed in terms of the currency of a sovereign nation state. Each note explicitly stated the authority who backed its exchange value, as can be seen in Figures 2.2.1 and 2.2.2. Hence in the international arena, the act of counterfeiting can be perceived as an attack on the sovereign, since a state's currency is a direct product of its sovereignty. This aids in understanding why counterfeiting occurs across nations.

2.3: Motives and Consequences for Counterfeiting Illustrated by Historical Cases

Counterfeiting is a costly undertaking, especially when producing high quality notes. These costs are both economic, as well as legal. The legal punishments for counterfeiting have been extremely severe throughout history, with most counterfeiters facing death. As such, analyzing the motives behind counterfeiting can help in understanding counterfeiting as an act of financial warfare, and why a country or organization may want to take on the risk and economic costs associated with counterfeiting in order to weaken an enemy. This can best be done through the examination of historical cases of counterfeit, and identifying major themes that have been recurrent throughout history.

Counterfeiting Purely as an Attack on the Sovereign

In some historical cases, counterfeiting has been used purely as an attack on the sovereignty of another country. In other words, the counterfeiting nation has no use for the forged notes other than using them as a weapon against an enemy country. One example of this is after World War I when the British counterfeited German imperial reichsmarks, smuggling them onto the continent to undermine Kaiser Wilhelm. This was a significant cause of the hyperinflation experienced by the Weimar Republic in the

1920's after World War I. At its highest point in 1923, one trillion reichsmarks were worth roughly one U.S. dollar (Cooley 2008: xiii). Another example dates back to 530 BC when Polycrates, the ruler of Samos, was in a war with many of the Greek city-states, who managed to get the Spartans to fight alongside them. In response to this, Polycrates had his mint issue a special issue of lead counterfeit coins covered with a wash of gold, which the Spartans accepted and bought off from the belligerent enterprise (Cooley 2008: 57-58). During the Vietnam War, the United States counterfeited the North Vietnamese dong as an act of war, with a tear-away warning attached saying:

> "The Communist Party is spending your money on a hopeless war. If the war goes on, there will be nothing for you to buy. The war is destroying your country. All your savings will be worthless." (Wolman 2012)

Both the act of counterfeiting and the written message on the counterfeit notes were a direct attack on the sovereignty and authority of North Vietnam's ruling regime.

One particularly famous historical instance incorporates the notions of counterfeiting as a pure attack on the sovereign as well as asserting sovereignty through the issuance of a state's own currency, the American Revolution. While many history books do not discuss the widespread counterfeiting during the American Revolution, it was actually a major element, and the role that currency played in general was relatively significant. Prior to the revolution, the colonies were issuing notes denominated in the currencies of other sovereign nations. However, this was proving to be extremely limiting, stifling economic growth, as the colonies only had a certain amount of British pounds or Spanish milled dollars on hand to back their currency. As a result, the colonies decided to issue their own currency, which ended up being rather successful and gave them significant economic independence. In response to this, the British issued the Currency Acts of 1751 and 1764, prohibiting the issue of new currency by the colonies (Tcherneva 2016: 9). As Goodhart (1998) said, "...the spatial determination of separate currencies has almost nothing to do with such economic cost minimisation and almost everything to do with considerations of political sovereignty." (409) Therefore, as colonizers, the British did not want the American colonies to be issuing their own currency, as this assertion of sovereignty would be in violation of their status as a colony. The American colonies were opposed to this, as it stifled their potential for economic growth, and served as another measure to ensure their subordinance to the British crown. The Currency Acts were one of the causes of the outbreak of the American Revolution.

During the Revolution, the Americans issued their own currency to finance the war, known as continentals. As an act of war, the British began counterfeiting continentals abroad the HMS *Phoenix*, a gunboat anchored in New York harbor. By April 1777, New York newspapers were running the following notice:

> "Persons going into other Colonies may be supplied with any Number of counterfeited Congress-Notes, for the Price of the Paper *per* Ream. They are so neatly and exactly executed, that there is no Risque in getting them off, it being almost impossible to discover, that they are not genuine." (Rhodes 2012: 34)

Loyalists distributed the forged dollars throughout the colonies. One of the most famous was Stephen Holland, a resident of Londonderry, New Hampshire, who organized a network of friends and acquaintances to distribute the counterfeit continentals. He was eventually captured, but before they could execute him, he escaped. In response to this, a New Hampshire patriot named John Langdon said, "Damn him. I hope to see him hanged. He has done more damage than 10,000 men could have done." (Rhodes 2012: 34) Benjamin Franklin understood the significance of the continentals not only as a counterfeited currency, but also their existence as a currency. Franklin said that not only was counterfeiting an act of war, but the act of printing genuine continentals was an act of war as well (Rhodes 2012: 34). In the War of Independence, the colonies were asserting their independence, the very thing that the British Empire was trying to keep them from attaining, by issuing their own currency. Additionally, another interesting point to note is that in counterfeiting the American continentals, the British were acknowledging the continental as a currency. Perhaps the continental was already winning the American Revolution before the colonists were from a military standpoint, given that the British were in a way acknowledging their sovereignty through their currency. Political sovereignty necessarily means monetary sovereignty (Tcherneva 2016: 9).

A similar instance occurred about a century later during the American Civil War. The Confederacy issued their own currency to assert their sovereignty from the Union, known as graybacks (in contrast to the Union dollars which were known as greenbacks). Printers in the North, such as Samuel

Upham and Winthrop Hilton, openly advertised their counterfeit graybacks, which had a small disclaimer on the bottom that could be cut off. This widespread counterfeiting left the graybacks nearly worthless, and Southerners conducted everyday trade and exchange using the northern greenbacks. Stephen Mihm, professor of history at the University of Georgia said, “The greenbacks were in some cases conquering the South before the Union soldiers got there.” (Rhodes 2012: 36) This can be differentiated from the American Revolution because in this case, the notes were being counterfeited by private entities, rather than the government. Hence, there was no acknowledgement of the grayback by the Union government.

The British had no use for the German imperial reichsmarks nor the continentals, just as Polycrates had no use for the worthless lead coins and the same with the Union and the graybacks. Thus, these instances of counterfeiting were done purely as a measure to weaken an enemy state.

Counterfeiting as Both Submission and Attack

While counterfeiting in some instances can be used purely as a means to attack another state, there is usually more at play. Counterfeiting may not be simply a way to attack the sovereign, it could also be a way to increase spending power or service debt. One example is Iran during the 1990’s when they were counterfeiting U.S. dollars. After the Iran-Iraq War, Iran wanted to rebuild its economy. It eventually became apparent that Iran’s exports could not meet its hard-currency needs, and as a result they devised a counterfeit operation. In light of the recent war and the U.S. trade embargo, Iran was in dire need of dollars to replenish stocks of arms, ammunition, and medicine (Cooley 2008: 25-26). Therefore, their counterfeiting operation was less an attack on the U.S., and more of a mission to replenish cash stocks amongst a declining post-war economy.

Stalinist Russia also provides a historical example of counterfeiting both as a means of attack as well as out of need for dollars. During the first Five-Year Plan, which extended from 1928-1932, there was heavy purchasing of foreign machinery and materials for the aggressive industrialization effort occurring in the Soviet Union at the time. However, a major consequence of this large effort was a shortage of foreign exchange in Moscow, with the fund of foreign exchange in the Soviet Treasury being inadequate for the first-line industrial departments, as well as the foreign divisions of the Joint State

Political Directorate (OGPU)[14] and the Soviet Military Intelligence who were in a critical budgetary condition while they too were expanding their services. As such, the Soviet government sought out "valuta", or gold and its equivalents, which became a major priority. A special Valuta Bureau was organized by the OGPU, and every conceivable method, from trickery to terror, was employed to pump foreign currency and other treasures out of the Soviet population (Krivitsky 2000: 101-102). This systematic extortion of relief remittances sent by relatives in America to members of the Soviet population became known as the Dollar Inquisition, where many victims were imprisoned and tortured by the OGPU until ransom money arrived from abroad (Krivitsky 2000: 102).

While the Dollar Inquisition was well known to the general public, there was another method through which Stalin acquired more dollars which he kept secret. This method was counterfeiting dollars, and Stalin established a counterfeiting ring in Moscow that was only known to a few top officials of the OGPU, and the distributors of the forged notes, who were Soviet agents. They primarily counterfeited $100 bills, and the notes were printed on a special stock of paper imported from the United States. The forged notes were so well-done that bank tellers in the United States accepted them for years after their first appearance as legitimate. The counterfeiters were so confident in the quality of their notes that they offered them in large quantities for exchange in leading American financial institutions (Krivitsky 2000: 102-103). It is interesting to note that the author of the book detailing this counterfeit operation, W.G. Krivitsky, was previously a top official in Stalin's regime who renounced Stalin and moved to the United States. He wrote this book and published it in 1939. Two years later, he was found dead in a hotel room. While it appeared to be a suicide, the Soviets had been after him for years, and Krivitsky had many times skirted assassination attempts by Soviet intelligence agents.

A decade later the Nazi's also started a counterfeit mission known as Operation Bernhard. These counterfeit notes were used to help fund the war effort, as well as a way to weaken the British, and later American, economy through currency destabilization. Additionally, the Germans used the forged notes to help finance their war effort, so there was additional utility coming from producing these counterfeit notes aside from simply weakening the sovereign (Rhodes 2012: 37). The plan was developed in 1939 by SS

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[14] The secret police of the Soviet Union from 1923 to 1934.

officers Alfred Naujocks and Bernhard Kruger of the Reichsicherheitshauptamt[15]. The operation was carried out by about 140 Jewish prisoners at Sachsenhausen concentration camp near Berlin, who were overseen by SS Sturmbannfuhrer Bernhard Kruger. These prisoners were previously criminals, artists, engravers, and other professions that would serve one well in the forgery of currency notes, and in return for their work their lives were spared and they were given better food and other privileges (Ruffner 2014: 42). The notes they produced were of such high quality that even bank officials in England and Switzerland accepted them as legitimate (Rhodes 2012: 37). By 1944, the total production of counterfeit notes by the Nazi's amounted to 13 percent of the £1 billion worth of real notes in circulation at the time, meaning that at least 1 pound out of 20 in circulation was false. If they had circulated this widely in the British Isles, such a high amount of fake notes would have been sufficient to slow down the British financial system, as well as the economy as a whole. However, the British had been warned of the counterfeit notes in newspapers, and the notes were primarily circulating on the European continent, namely in the Mediterranean basin and Hungary (Malkin 2006: 146-147). For instance, in Budapest, a five-dollar bill could be exchanged for a five-pound note on the black market by late autumn 1944, indicating that the sterling had collapsed by about 75 percent from the official rate, which was about $4 to the pound. A young Budapest trader later known as George Soros was aware of this, and at 14 years old was sent by his father to conduct a deal where he had a heavy gold bracelet to trade on commission for cash. Young Soros was paid about £5000 which he feared were fake, however his father's clients accepted it. Someone down the line most likely ended up with a bunch of counterfeits. (Malkin 2006: 147)

Toward the end of the war in 1945, the inmates had to be relocated to an unused brewery at Redl-Zipf in Austria, however there was little time to resume their counterfeiting operations. By the last week of April, the Germans ordered the prisoners to destroy as much of the machinery, forged notes, and records as possible. In one of the last acts of World War II, the Nazi's in a desperate attempt to cover up their counterfeiting operation dumped crates of counterfeited notes into Lake Toplitz and moved the prisoners to Ebensee concentration camp. The U.S. Army's liberation of that camp on May 6 prevented

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[15] The German National Security Office.

the Nazi's from having the chance to execute these prisoners (Ruffner 2014: 43). Holocaust scholar Rabbi Marvin Heir said, "Had this counterfeiting operation [been] fully organized in 1939 and early 1940, the results of World War II may have been quite different." Luckily, it took until 1942 for the Germans to put Operation Bernhard into high gear (Ruffner 2014: 42).

A last example is North Korea's production of supernotes during the mid-2000's. After discovering a large shipment of high-quality forged notes into Newark, and subsequently additional large shipments that appeared to be from the same source, the U.S. discovered that these notes were coming from the government of North Korea. While North Korea denied involvement, intelligence was pointing at them as the source, as well as North Korean defectors, one of which reported that Kim Jong Il endorsed counterfeiting not only as a way to finance covert operations, but also as a way of waging financial warfare on the United States. This idea originated decades prior in 1984 when Kim Jong Il issued a directive to produce and counterfeit American dollars as a means to overcome their economic crisis. Mihm characterized this crisis as twofold: while the conditions amongst the North Korean population were worsening, there was also financial discontent amongst the regime's elite, who were used to a certain standard of living. As such, these counterfeit notes were used to purchase foreign-made cars, elaborate vacations, and fine wine and cognac for the elite. A North Korean specialist paraphrased Kim Jong Il's words on his motives to counterfeit to American intelligence officials: "...a way to fight America, and screw up the American economic system." (Mihm 2006) Counterfeiting was also perceived as an expression of the guiding ideal of the North Korean regime: juche. Juche can be translated as "self-reliance" or "sovereignty", and the idea behind this concept involves the aggressive repudiation of another nation's sovereignty (Mihm 2006). As a result, the U.S. Treasury froze North Korean bank accounts, which analysts say was what led to the North Korean regime's decision to launch its missiles on July 4, 2006 (Mihm 2006).

In looking at these historical instances of counterfeit, the boundary between counterfeiting as a way to undermine the sovereign versus a way to expand purchasing power is not very clear. This raises the question, to what extent do countries need to counterfeit the currency of a global hegemon, and therefore in challenging that nation's sovereignty are simultaneously succumbing to it?

Looking at Stalinist Russia, Nazi Germany, and North Korea, we see that with the development of the formal financial system, that these relationships are much more complicated. In all three instances, a major global reserve currency, issued by a geopolitical hegemon, was the currency being counterfeited. Why did the Soviets choose dollars to counterfeit, the Nazi's choose pounds as well as dollars, and the North Koreans choose dollars? They chose these currencies because they are the currencies worth counterfeiting. If a nation wants purchasing power in the global financial system, they want a powerful global reserve currency, which would in theory make up for the costs associated with the counterfeiting itself. Thus, in counterfeiting dollars, for instance, there is acknowledgement that the United States currency has power, and by extension, as does the United States as a nation. The Soviet Union, Germany, and North Korea were not just counterfeiting with the intent to attack the sovereign, because in reality the effect on the U.S. economy of counterfeiting operations, especially today, is minimal at best. Whether or not they realized it, the counterfeiting was primarily symbolic, a way to offend the sovereignty of the United States (or Great Britain), as well as a way to perhaps lift a depressed economy out of a purchasing power slump, such as Iran and North Korea, finance a war, such as Germany, or help their own economic growth, such as the Soviet Union. However, in doing so, these countries were to some extent antagonizing their own efforts, for in counterfeiting U.S. dollars and acknowledging the power of the dollar, they were to some degree succumbing to its power. Despite this, throughout history monetary hegemons, such as the United States today, have taken the counterfeiting of their currency very seriously, and have agencies dedicated to intercepting counterfeiting efforts, as well as severe punishments for those caught counterfeiting their currency.

The Secret Service: Protectors of American Sovereignty

After the Civil War, the United States needed to no longer be a collection of autonomous states and become a nation. One of the measures taken was unifying the country under one currency. The dollar became the affair of the state, and the Constitutional right of the federal government to coin money, and its denial of that right to individual states, was enforced (Mihm 2007: 3; Goodwin 2003: 248). As Goodwin (2003) said, "...the dollar now represented the sovereign majesty of the United States." (248)

Thus, counterfeiting became a serious offense, as the dollar now was a direct reflection of the federal government:

> "Confidence in the currency no longer rested on the diffuse and almost infinite number of variables that governed that values of privately issued bank notes. Rather, it depended on faith in a new abstraction--the nation--that transcended both the market economy and the individuals and corporations constituting it. As a consequence, counterfeiting went from being a nuisance to being a threat to national sovereignty and sanctity." (Mihm 2007: 19)

As a result, Congress ruled flash notes illegal in 1867; even toy shops that sold games that used fake money were forced to surrender those materials. For instance, R.H. Macy in November of 1881 had to surrender 160 boxes of toy money for destruction (Goodwin 2003: 249). To further protect the sanctity of the U.S. currency, the government created a special agency tasked with preventing and thwarting counterfeit operations. In 1865, President Abraham Lincoln signed into law the creation of the Secret Service, which still exists today with the same task of preventing counterfeiting. Ironically, on the same day that President Lincoln signed the Secret Service into existence, April 14, 1865, was the day he was assassinated. Even more ironically, today the duties of the Secret Service have expanded to encompass protecting the president from assassination (Cooley 2008: xiii). Today, the Secret Service has offices in many prime locations for counterfeiting activity, such as Bangkok, Berlin, Bogotá, Bucharest, Frankfurt, Hong Kong, Lagos, London, Mexico City, Milan, Moscow, Ottawa, Paris, Pretoria, Rome, Sofia, Toronto, and Vancouver. Through these offices, the Secret Service can work closely with local police and government agencies to prevent counterfeiting operations, and be able to take part in investigations (U.S. Treasury Dept. 2003: 54).

Punishments for Counterfeiting

Throughout history, the punishments for counterfeiting have been relatively brutal. Listing some of these punishments, after having just described the Secret Service, will illustrate how seriously counterfeiting is taken by sovereign governments. Whether or not counterfeiting poses an economic threat, counterfeiting is still a serious offense, as it directly reflects a threat to a country's sovereignty.

The more vicious punishments go far back in history. For instance, Emperor Constantine the Great of Rome had offenders burned alive. In the early Roman Empire, counterfeiters who clipped precious metal from coins were punished by having their ears clipped or cut off, as well as were deprived of Roman citizenship. Later, their noses were also cut off, and eventually they were castrated and thrown into a pit to be devoured by hungry lions. In the seventh century AD, people caught counterfeiting had their hands cut off. In China during the sixth century AD, counterfeiters were punished by having their faces tattooed, and by the seventh century AD, counterfeiters, as well as their families and neighbors, were subject to the death penalty. In Anglo-Saxon England under King Athelstan (924-40), counterfeiters were tortured and executed. Under King Canute (1014-35) both hands were cut off. During the reign of King Edward II (1307-27), they were drawn and hung. In Massachusetts in 1679, Peter Lorphelin, a Frenchman who had counterfeiting materials, was sentenced to two years in a pillory, had both ears cut off, and had to pay a fine of 500 pounds (Cooley 2008: 59-70). Notes have also traditionally had threats on them to counterfeiters, such as the early Chinese banknotes which had the phrase "Death to Counterfeiters" on them, as well as the colonial banknotes, which had a variety of phrases all meaning the same thing: "Tis death to counterfeit", "To counterfeit is death", "Death to counterfeit". After the 9/11 terrorist attacks in the United States, Congress decided to crack down on financial crimes. Therefore, in the USA PATRIOT ACT of 2001, existing counterfeiting statutes were modified to accommodate emerging and future technologies, such as digital technology, and strengthened the maximum statutory penalties for counterfeiting violations (U.S. Treasury Dept. 2003: 66).

2.4: Concluding Remarks

While the actors have changed over time, the motives behind counterfeiting and its significance have remained the same throughout history. Common themes can be found from Ancient Rome to the American Revolution to World War I, and the consequences for counterfeiting have remained severe as well. Examining these counterfeiting relationships sheds light on the theoretical implications of counterfeiting, and its ties to Chartalist monetary theory. These relationships also add to the dialogue of financial warfare, and the ways in which countries use money and credit in acts of foreign aggression. In particular, counterfeiting as an act of war is an asymmetric form of warfare. Looking at the historical cases presented in this chapter, major powers typically counterfeit solely to weaken the sovereign, and minor powers counterfeit not only as a way to challenge the sovereign, but also because they need that money. Today, that line has become even more blurred, as the international financial system has materialized and a currency hierarchy has been developed. At their essence, these counterfeiting operations have been closely tied to the power of a sovereign, whether it be challenging it, or asserting it. A major factor in the rise of the United States as a geopolitical hegemon was its organization under the U.S. dollar, and the major factor behind the rise of the U.S. dollar as a global reserve currency was the fact that the U.S. is a geopolitical hegemon. As Tcherneva (2016) said, political sovereignty necessarily means monetary sovereignty, each go hand in hand (9). While there is a lack of data on the official numbers on counterfeiting, it would not be a surprise to learn that the U.S. dollar is the most widely counterfeited currency today.

Ch. 3: Financial Sanctions

"It is hard to imagine any serious foreign policy issue down the line in which financial tools would not be or should not be considered as part of a comprehensive strategy."
- Rachel L. Loeffler

As a foreign policy tool, sanctions have been celebrated as a more attractive alternative to military intervention in either coercing a state into changing a specific policy or even a signal of overall opposition to a regime. The use of sanctions has only grown recently, namely since the end of the Cold War. The United Nations Security Council voted for economic sanctions twelve times in the 1990's, whereas between 1945 and 1990, they only implemented sanctions twice. There were about as many sanctions episodes after the completion of the Cold War as there were during the first ninety years of the twentieth century (Drezner 2011: 97). While starting as comprehensive economic sanctions, such as trade embargoes, sanctions have evolved to be much more targeted with a more specific financial focus, such as asset freezes and blocking transactions. Financial sanctions are generally perceived to be more ethical than comprehensive economic sanctions, as they typically target the political elite who are behind the policy decisions, rather than the masses, who typically are the ones who suffer the most from embargoes and other comprehensive economic measures. As such, the use of financial sanctions within the past few decades has risen exponentially while the use of comprehensive sanctions has decreased. While the primary policymaking body that issues sanctions is the United Nations' Security Council, the United States has taken a leading role in implementing sanctions policy unilaterally, as well as in encouraging multilateral cooperation from other regions such as the European Union, Asia, and the Gulf Cooperation Council (GCC).

However, given that one's position of economic power as well as their position in the international financial system clearly have a direct relationship with both their ability to implement sanctions as well as their vulnerability to sanctions, it follows that there are going to be states in more advantageous positions than others. This ties back to Pistor's argument on apex versus periphery countries, as well as the spatial hierarchy of the dollar. Given the dollar's position as the hegemonic currency, it follows that the U.S. may be the ultimate apex country in the international arena. As such, in looking at the argument on the United States' position to implement financial warfare, it becomes clear that on the sanctions front, the United States is in a rather special as well as unique position to play a significant role in influencing policy decisions worldwide through its sanctions implementation. This chapter will go into depth on the reasons behind which the United States solely holds this position, and as such this chapter will be looking at the legal origins of economic and financial power. Financial sanctions are an extension of the power of the sovereign beyond national borders. This chapter focuses on the implementation of sanctions by one state on another state. Thus, we examine how a powerful sovereign can undermine the sovereignty of another state, despite the fact that that state lies outside of its legal jurisdiction. Two examples of countries who sovereignty was directly undermined by the United States are Argentina and Iran. In the example of Argentina, a U.S. hedge fund called Elliot Capital Management seized the Argentinian ship *ARA Libertad* in response to a dispute over Argentinian bonds. As a result of Argentina's financial crisis, in 2005 and 2010, about 93 percent of Argentina's $100 billion in defaulted bonds were restructured, leaving holders receiving only 30 cents to the dollar. Elliot Capital Management is suing Argentina for the full recovery of its assets. U.S. courts have ruled $1.6 billion in claims in favor of Elliot (Jones and Webber 2012). Iranian officials are outraged at the United States after the Supreme Court ruled in April 2016 that families of the victims of the 1983 Beirut bombing be compensated with $2 billion in Iranian funds (New York Times 2016). These funds are coming from the frozen Iranian assets held by the United States. President Hassan Rouhani characterized this decision as "flagrant theft and a legal disgrace" (New York Times 2016). In both instances of Argentina and Iran, the United States has directly undermined these countries' sovereignty by allocating their assets to private entities. This is a clear picture of the U.S.'s hegemonic position, given that it has taken assets of other countries and simply has done with them as they see fit.

As such, financial sanctions are a major element of financial warfare, and examining the mechanics behind their implementation is important, as well as what factors determine success in their implementation. Furthermore, these weapons are potent, and as such, many states are concerned about the power that the United States possesses in this arena. This poses a potentially concerning question: does the legal jurisdiction of the United States extend beyond its borders and entities? Examining financial sanctions sheds light on the legal origins of the U.S.'s strong influence on economic policy as well as the international financial system. Furthermore, this chapter will also argue another major point of these paper, which is that caution must be exercised in the implementation of financial weapons, as the implications of their implementation are powerful. Learning more about these tools of financial warcraft is essential, as their proposed benefits may not hold true in practice.

3.1: Defining Financial Sanctions

Before going into the discussion, it is essential that we first define financial sanctions, as well as distinguish them from other types of sanctions. The first distinction to make is between economic and financial sanctions, which are terms that are sometimes incorrectly used interchangeably. Economic sanctions are comprehensive in nature, and throughout the nineteenth and most of the twentieth centuries, were essentially the only type of sanctions implemented. Typically, economic sanctions came in the form of trade embargoes. However, as a result of the rise of globalization and the development of a sophisticated international financial system, sanctions have become more targeted. Additionally, the ethics of implementing comprehensive sanctions have been questioned, as they typically cause widespread economic hardship on the population of the target country, while the political elite remain essentially untouched. In authoritarian political systems, such as Iraq in the early 2000's, hardship amongst the country's masses is typically not a sufficient condition to induce a policy change. As a result, comprehensive economic sanctions can also increase nationalistic resistance to outside pressure (Gibson, Davis, and Radcliff 1997: 610).

Thus, targeted, or "smart" sanctions have taken the place of comprehensive sanctions. These include travel bans, arms embargoes, and financial sanctions. Drezner (2011) characterizes targeted sanctions as "the precision-guided munitions of economic statecraft" (96). Arguably the most potent tool in the smart sanctions arsenal, financial sanctions include asset freezes of governments, individuals, and/or corporations, barring loans from international financial institutions (i.e. the International Monetary Fund), suspending the convertibility of a country's currency, and tightening the conditions of debt repayment (Gibson, Davis, and Radcliff 1997: 616). The use of financial sanctions was developed during the Clinton administration as a response to states whose policies abused the financial system, for instance through having lax anti-money laundering policies (Drezner 2011: 101). It makes sense to concentrate the income losses on those who are creating and benefitting from the policies in question (Gibson, Davis, and Radcliff: 1997: 610). Zarate (2009) calls the switch from comprehensive economic sanctions to targeted financial sanctions a change in paradigm, which is an interesting point. This new paradigm disposes of the old notion of sanctions being either unilateral or multilateral. Under targeted financial sanctions, sanctions have become multilateral by nature, due to the fact that the international financial community becomes strongly involved in ensuring that sanctioned entities do not abuse the financial system (44). This multilateral cooperation spans states, international organizations, as well as the private sector.

In the United States, financial sanctions are implemented through U.S. Statutes and Executive Orders, and appear in the form of regulations. The Office of Foreign Assets Control in the Department of the Treasury works with the Department of State and sometimes other federal agencies to implement financial sanctions, and make sure that they are being adhered to (Carter and Farha 2013: 904).

3.2: Existing Literature on Financial Sanctions

There is a great amount of existing literature addressing the efficacy of sanctions, as well as the necessary preconditions that need to exist in order for sanctions to have a successful outcome. However, there is also literature that posits that sanctions are not effective, and even literature that says the existing literature is useless for policymakers who are faced with real-world issues. This disconnect in the existing literature is concerning, but an examination of the existing literature is still necessary, as some of the ideas that the authors discuss are of interest, as well as the points at which the literature conflicts.

Gibson, Davis, and Radcliff (1997) propose that in general, there are two types of sanctions. There are sanctions that are designed to coerce the target into making a policy change, and those that are more retributive in nature, where the goal may simply be destabilization, or even a gesture of disapproval toward a regime (610). They argue that the latter goal may be more easy to achieve, as a country has no decisive power over whether or not to be destabilized or disapproved of, whereas they do have that power over their policies. As such, they say that the determinants of success of sanctions may depend upon the goals of the implementing entity. In a regression analysis, Gibson, Davis and Radcliff separated the different goals of sanctions implementation, and found that different factors contribute to the success of sanctions dependent upon the intended goal of the sanctions regime. When the goal is destabilization, factors such as the costs to the target country of the sanctions, the economic health of the target country, as well as the duration of the sanctions have a statistically significant impact on the effectiveness of sanctions in achieving their goals. However, for all other goals, such as coercion to change policy, factors such as the use of financial sanctions have a statistically significant impact on the effectiveness of sanctions (613). The success of financial sanctions in achieving policy change is likely due to the fact that financial sanctions directly target the political elite, who are the ones making the policies. This point is supported by other authors, as pointed out by Gibson, Davis, and Radcliff, such as Alerassool (1993), Kaempfer and Lowenberg (1992), and Morgan and Schwebach (1993) (615). Kaempfer and Lowenberg (1988) also support this point, using a public choice approach which examines public policy as an endogenous outcome of competitive interest group pressures within the sanctioning and target countries (792-793).

The relationship between a target country and a sending country is also important in determining the success of sanctions implementation. Factors such as the extent to which the target country relies on the sender country for imports and exports, the political and economic stability of the target, as well as the duration of the sanctions need to be considered (Gibson, Davis, and Radcliff 1997: 609). There are two different arguments pertaining to the duration of sanctions: one argument is that longer sanctions are more effective, as the costs to the target of sanctions increase over time, and the other argument is the shorter sanctions are more effective due to the fact that if sanctions are not immediately successful, prospects of success will wane over time (Gibson, Davis, and Radcliff 1997: 609-610). In reality, both arguments likely exist in a duality, and the effect of one dominates the other likely depending on the circumstances surrounding the sanctions.

Another significant factor to consider in assessing whether or not financial sanctions will be successful is the political regime in power in the target country. In comparing democratic regimes versus authoritarian regimes, it is apparent that they may respond to different incentives. For instance, authoritarian leaders are more likely to be concerned with the welfare of themselves and their inner elite circle rather than the masses, whereas a democratic leader in theory would be more concerned with the condition of the masses. As such, comprehensive economic sanctions would have a higher probability of succeeding in democracies rather than in authoritarian regimes. In looking at financial sanctions, they may have much more pull when targeting an authoritarian regime, as rulers such as Saddam Hussein and Kim Jong-un rely on their inner circles to stay in power, and therefore are mostly concerned with their interests. They have stronger incentives to create private and excludable goods for their supporters, rather than public goods for the masses (Drezner 2011: 100). Thus, if targeted sanctions were causing income losses in the political elite, it makes sense that authoritarian rulers may respond more strongly to that than comprehensive sanctions. Drezner (2011) argued that comprehensive sanctions actually increase an authoritarian ruler's grip on power, as they create the opportunity for target government leaders to allocate rent-seeking opportunities to their supporters (100).

Drezner (2011) also states that all of the econometric literature of the past decade is in agreement that if the target state is a democracy, then comprehensive sanctions are likely to result in quick concessions (102). It has also been found that sanctions across the board have reduced the staying power of the target government, while military action tends to increase the duration of power of a given regime (Drezner 2011: 102). Tostensen and Bull (2002) also make a similar argument, which is that targeted financial sanctions are most likely to be effective against corrupt dictators in countries with few resources or limited opportunities for the accumulation of resources, where the regime is more interested in accumulating private wealth than protecting the welfare of the masses, and without a developed banking system or stable currency (388). Tostensen and Bull also list some difficulties that arise in the implementation of sanctions regimes: the effectiveness of sanctions is determined by inadequate research methods, the goals of the UN Security Council and its members often diverge, the economic success of sanctions does not necessarily guarantee their political success, sanctions typically have unintended consequences, the UN system is not well-equipped to administer sanctions, and sanctions are often used to preclude war, which is concerning as sanctions are implemented as an alternative to war, not a complement (394-395).

Some of the concerns brought up by Tostensen and Bull illuminate that there exist many deficiencies in the existing literature surrounding financial sanctions. Firstly, examining financial sanctions as a whole can lead to misleading conclusions. The term "financial sanctions" encompasses a broad variety of strategies, including asset freezes, barring loans, and suspending the convertibility of a currency. Each of these different strategies has different consequences. For instance, the argument that financial sanctions are a more ethical alternative to comprehensive economic sanctions may not hold true when the sanctions suspend the convertibility of a currency, or freeze the assets of a nation's central bank. In these instances, the ability of a country to pay for imports is diminished, and thus this damper on trade likely affects the general population. As such, perhaps financial sanctions are not ethical in all instances. Furthermore, this raises the question: to what extent do financial sanctions encompass economic sanctions? Perhaps the dichotomy between the two is not as strong as the literature suggests.

Drezner (2011) also argues that the existing literature is not even useful for policymakers. The questions that are addressed, as well as its conclusions are on issues of limited relevance to today's policymakers (99). For instance, literature that examines "what percent of the time" are sanctions effective, such as Hufbauer et al. (1990) and Baldwin and Pape (1998) do not really serve to help much in addressing real-world questions. Literature that specifies very particular circumstances in which sanctions are effective, such as some of the studies mentioned above, as well as Bolks and Al-Sowayel (2000), Allen (2005), Morgan and Schwebach (1997), Ang and Peksen (2007), does not help policymakers when they are faced with countries like North Korea and Iran (Drezner 2011: 99).

Therefore, Drezner (2011) makes the statement: "Any assessment of targeted sanctions at this juncture must be labeled as preliminary." (102) Additionally, financial sanctions have only been used for the past couple of decades, and therefore there is a strong lack of empirical substantiation for the claims made in the literature. This has lead to a potential fallacy in the existing literature, which is taking specific sanctions episodes, and drawing general conclusions from them. In other words, the literature may be extrapolating general propositions from high-profile cases (Drezner 2011: 105). While this is a major fallacy, it may be the only option at this point in time, due to the infancy of financial sanctions as a policymaking tool. Despite this fact, there is still a good deal to be learnt from existing sanctions episodes.

3.3: The Iranian Case

An example of a case where the literature has taken specific instances of sanctions implementation and drawn general conclusions from them is Iran. The story of U.S. sanctions use in Iran is often cited as a case for the success of financial sanctions. However, firstly it is important to examine the preconditions that existed in Iran prior to the sanctions implementation in order to assess the factors that contributed to the sanctions' success, and we also must be more clear about what is meant by "success." Yes, these sanctions were successful in that their intended goals of releasing the U.S. hostages as well as reaching an agreement on the Nuclear Deal were achieved, but this came at a price. These sanctions had a depressing effect on Iran's business environment, as well as on its economy in general, hurting its population. Perhaps the Iranian case could be an argument against the proposed benefits of the use of financial sanctions; namely the idea that financial sanctions are a more ethical alternative to comprehensive economics sanctions, due to the fact that they supposedly do not hurt the general population, only the political elite.

Sanctions were first implemented on Iran a few decades ago in response to a hostage crisis. On November 4, 1979, fifty-two Americans were taken hostage in Iran, and in response, President Carter froze all assets of the Iranian government in the United States as well as all Iranian assets under the control of U.S. banks, businesses, and individuals outside of the United States only ten days later. This sanctions episode effectively froze over $12 billion in bank deposits, gold, and other property (Carswell 1981: 247). This struck pretty hard in Iran, which was already experiencing economic hardship as a result of the Iran-Iraq War and its economic isolation. There was also something that was unprecedented in this sanctions episode: this asset freeze included over $5.6 billion of deposits in securities held by overseas branches of U.S. banks. This was the first time in history that any significant amount of assets overseas had actually been caught in a sanctions episode. For the international arena, the idea that with the simple stroke of a pen, the President of the United States froze over $5.6 million of Iranian deposits held overseas, and kept them frozen for 14 months, may be a bit disconcerting (Carswell 1981: 249). In theory, the expanse of the U.S. jurisdiction is limited solely to those located in the United States as well as U.S. entities abroad, however how about in practice? This began to shed light on the strong influence the U.S. has on the international financial system.

According to Carswell (1981), this overseas asset freeze was justified on two grounds: every country has the right to exercise power over its nationals despite their location, and in other instances the U.S. has even been known to assert power over property held by Americans abroad; and accounts in other countries that are held by U.S. banks are also subject to the U.S.'s legal jurisdiction (250). On the second point, other countries objected to this extension of U.S. power, and thus the accounts of U.S. banks held abroad in other currencies were subsequently unfrozen, as the amount was not significant (Carswell 1981: 251). The U.S. also expounded a lot of effort to make sure that their sanctions were adhered to. The Department of Justice monitored and intervened in lawsuits all across the United States concerning the frozen assets, it also engaged counsel in the United Kingdom and France, and while the hostages were being held, the Treasury was continuing to release regulations and interpretations, as well as sending representatives to officials at banks and corporations who held frozen Iranian assets. The majority of the Iranian overseas deposits that were frozen were held by ten banks, the major one being Bank of America. These officials made an effort to understand the claims these entities held against Iran, which served them very well when it came time to settle with Iran (Carswell 1981: 252). Despite this otherwise large extension of U.S. legal power and the fact that most felt that the U.S. had overreacted, other countries did nothing else to oppose it. Just like the opinion of the literature surrounding sanctions, they saw it as a favorable alternative to military intervention.

Eventually, the sanctions were successful in getting the American hostages released, however, these were not the last sanctions that the U.S. implemented on Iran. As a result of conflict and tension surrounding the possibility of the proliferation of nuclear weapons in Iran, the United States imposed tight sanctions on Iran again only a few years later. This financial sanctions regime was comprised of multiple components, with the key legislative items being: the Comprehensive Iran Sanctions, Accountability and

Divestment Act of 2010 (CISDA); the USA PATRIOT Act money laundering designation of 2011; the National Defense Authorization Act of 2012 (NDAA); the Iran Threat Reduction and Syria Human Rights Act of 2012 (ITRA); and the National Defense Authorization Act of 2013, including the Iran Freedom and Counter-Proliferation Act (IFCPA) (Carter and Farha 2013: 911). As a result, it was nearly impossible for any U.S. financial institution to interact with an Iranian entity. Additionally, the Iranian Revolutionary Guard Corps (IRGC) posed a major security threat to the U.S. The IRGC was the military and intelligence arm of the Iranian clerical regime, who was dedicated to protecting the regime in place. As such, the IRGC supplied terrorist organizations such as Hezbollah and Hamas with weapons, training, and funding, as well as were strong supporters of the development of an Iranian ballistic missile system. Thus, on October 25, 2007, the U.S. Department of State and Department of Treasury designated the IRGC, as well as nine IRGC companies, five it its leaders, the Ministry of Defense and Armed Forces Logistics, Bank Melli, and Bank Mellat of Iran as proliferators of weapons of mass destruction. In addition, the U.S. also designated the IRGC-Qods Force and Bank Sederat of Iran as supporters of terrorism. The United Nations also followed suit, and the FATF published measures that countries should take to avoid doing business with dangerous Iranian entities (Zarate 2009: 53). Due to the IRGC's heavy involvement in commercial activity, in conjunction with the sanctions, the international financial system had an added incentive to withdraw from Iran due to the difficulty of discerning between legitimate financial activity and illegitimate activity funding weapons proliferation in Iran (Zarate 2009: 53).

These sanctions, as well as the negative attention they brought to Iran across the globe, hurt Iran's economy. Given the uncertain business environment in Iran, investors' interest in long term investments in Iran decreased, and the private sector reduced, and in some cases even ceased, its activities with Iranian entities (Habibi 2008: 4; Zarate 2009: 52). Examples of such private sector pull-outs include British Petroleum (BP) and Conoco Philips, both of which are energy companies (Zarate 2009: 52). The financial sanctions targeted Iran's oil industry in particular, which accounts for 60 percent of Iranian government revenues and 90 percent of export revenues. Furthermore, the sanctions have also increased corruption, rent-seeking, and illegal trade in Iran, as a result of the decreases in the inflow of petrodollars and decreasing foreign exchange reserves. This also negatively impacts the Central Bank's ability to clear the foreign exchange market and defend the fixed exchange rate (Farzanegan 2013: 15). As a result, the Iranian government began to impose restrictions on the foreign exchange market and increase government revenue through higher taxes. It should come as no surprise that the foreign exchange restrictions increased opportunities for rent-seeking for a small group of well-connected traders (Farzanegan 2013: 16). Furthermore, the higher taxes pushed many people out of the formal economy and into the informal economy, which not only defeats the purpose of implementing high taxes in the first place, but also serves to further hurt Iran's economy, as well as its population.

Again, these sanctions were eventually successful, in one sense of the definition, in January 2016 when the Iran Nuclear Deal was agreed upon by the U.S. and Iran, followed by the subsequent lifting of the sanctions against Iran. However, they came at a large cost. These sanctions had a major impact on the Iranian economy. Furthermore, many have drawn the conclusion from the sanctions episodes with Iran that financial sanctions are effective, as they achieved their proposed goals. However, there are certain preconditions that existed in Iran making this situation unique. For instance, prior the sanctions episodes of the 1980's, there were a large amount of Iranian assets under U.S. control, and comparably much less U.S. assets under Iranian control, the sanctions were also tied to an event that was something that could be resolved rather quickly, and U.S. allies also had interests to protect in Iran (Carswell 1981: 260). These factors played a major role in the ability of the sanctions to achieve their goal, and they do not hold true for every other country that the United States imposes sanctions on. Therefore, we cannot draw a general conclusion from these isolated episodes.

Furthermore, the Iranian case also reveals the extent of the U.S.'s power to influence the international climate surrounding a given entity. Not only did the U.S. financial sanctions impact the business activities of U.S. entities, but also non-U.S. entities, such as BP, which is a British-owned company. This brings in the interesting symbiosis of law and finance, which seems to give the United States much of its power and influence in the international arena. The U.S. clearly spearheaded the efforts in the Iranian sanctions episodes, and while even some countries felt that the U.S. had overreacted, none of them dissented against the U.S.'s wishes, but instead they abided by them. It is likely the case that no other country holds this power in the international arena, over both legal as well as financial issues.

3.4: When Sanctions Did Not Work

North Korea is an example of another major regime targeted by U.S. financial sanctions. Pyongyang has been involved in developing weapons of mass destruction, as well as in creating a large counterfeiting operation of U.S. dollars, and distributing these "supernotes" across the world. They also do not keep their anti-U.S. sentiment a secret, and as such, they are a major public enemy of the United States. In September 2005, under Section 311 of the USA PATRIOT Act, the Treasury designated Banco Delta Asia, a small private bank in Macau. The Treasury demanded that all U.S. financial institutions close any corresponding accounts with this bank. Banco Delta Asia had facilitated money laundering, proliferation, and counterfeiting on behalf of the North Korean regime (Zarate 2009: 51; Loeffler 2002: 103). What followed is what Zarate (2009) described as "market-based financial furies against North Korea", where banks in Asia and Europe also stopped doing business with Pyongyang, which effectively denied North Korea access to the international financial system (51). North Korean public officials were watched closely, and private entities, much like in the Iranian episode, separated themselves from North Korean entities. This was with good reason, given that in 2015, under Executive Order 13687, OFAC began to target entities and individuals that were working with Pyongyang, and under Executive Order 13382, U.S. inter-agency workers began to create a list of designated entities (Berger 2015: 3). Being on that list would mean a financial death, and no one wanted to risk being put on it, especially given the fact that under Article 311 of the USA PATRIOT Act, the Treasury can designate any entity that they believe poses a risk to the health of the international financial system, with or without hard proof. Furthermore, South Korea, who at first had been hesitant to get onboard with the sanctions regime against its dangerous neighbor, introduced the May 24 Measures in 2010, effectively cutting off practically all trade with North Korea, in addition to denying the access of North Korean ships to sea lanes (Berger 2015: 3).

With these sanctions and isolation from the international financial system, one would think that the North Korean story would end up much like the Iranian one. However, different conditions existed in

North Korea that caused the North Korean case to go in a different direction. North Korea has actually been able to endure international financial sanctions. This fact has nothing to do with its economic or industrial strength, but instead with its domestic ideology of *juche*, or self-reliance and self sufficiency (Berger 2015: 4). North Korea abides by this ideology, which stresses first and foremost deterrence of external threats, as well as puts nuclear weapon proliferation as a top security priority. Thus, the reasoning behind the ineffectiveness of sanctions against North Korea is twofold: North Korea does not want dependence on any other country, and thus isolation from the international financial system is not a crippling blow for them, and the proliferation of weapons of mass destruction is a top priority for the North Korean regime, and something they are not willing to negotiate on.

Another instance where U.S. financial sanctions were not effective is Haiti. According to Cortright, Lopez, and Rogers (2002), "If Iran is the classic case of successful assets freezing, Haiti is the prime example of failure." (28) These sanctions were implemented in May 1994, in response to a coup d'état that had occurred in Haiti, which could have had potential implications for other countries. These sanctions initially froze the assets of the Haitian government and its controlled entities, and eventually also encompassed assets of designated military, police, and government officials who were participating in the military junta. These sanctions were poorly implemented, and included many loopholes through which Haitian officials could get around. Firstly, the UN Security Council May 1994 resolution only "urged" states to freeze assets, but did not require it. In addition to that, the U.S. asset freeze on Haitian officials only included transfers from the U.S. to Haiti. Therefore, Haitians were still able to move their money from their accounts in U.S. banks to other countries, and subsequently back to Haiti. They could also simply withdraw cash and spend it in the United States (Cortright, Lopez and Rogers 2002: 28). This case shows how only a few decades ago, sanctions were still in their infancy, and thus we still only have limited exposure to sanctions implementation and what they are capable of.

Nearby in Cuba, the United States had also used an asset freeze, along with economic trade sanctions, in 1962 in response to Cuba nationalizing the properties of various U.S. nationals in its country. However, these sanctions were ineffective due to the fact that the U.S. property seized by Cuba was worth at least ten times as much as the Cuban assets blocked by the U.S. President Castro therefore viewed these sanctions with much amusement (Carswell 1981: 259).

There have been many episodes where financial sanctions have not proven effective, and therefore successful implementations cannot be generalized as the norm. Every country is different, and therefore their relationship with the sanctioning country as well as the international financial system is different, which plays a major role in their response to sanctions implementation. The point to be made here is that we need to better understand tools of financial statecraft before we become so eager to implement them on a regular basis.

3.5: The U.S. Legal Reach

Cases of financial sanctions implementation have revealed that the extent of the U.S.'s legal jurisdiction expands beyond U.S. entities. Most of the world listens when the U.S. uses sanctions against a given entity, whether or not they technically have to abide by U.S. law. Thus, financial sanctions reveal another major arm of the U.S.'s position as a global political and economic hegemon, which from a legal perspective. Due to its leading position in the international financial system, countries do not want to be the target of U.S. financial sanctions, as that would mean potentially being cut off from the international financial system. Hence, the U.S. is likely unique in the fact that its legal jurisdiction essentially expands to non-U.S. entities. As Berger (2015) said, "U.S. sanctions...are not exclusively a concern for U.S. entities." (3) An example of the U.S. exerting power over foreign entities, who technically do not have to abide by U.S. law, was Executive Order 12938, which made it possible for the U.S. to sanction foreign entities that have attempted to engage in proliferation and deny them access to the U.S. market (Berger 2015: 3). This statement is vague, and therefore everyone has to be careful, as it applies to countries directly engaged in proliferation, such as North Korea, as well as any bank, country, or any entity that is indirectly associated with an entity engaged in proliferation. With the threat of being closed off to U.S. markets too dire, countries listen. Another example is ITRA, which prohibited entities "owned or controlled by a United States person and established or maintained outside of the United States" from knowingly engaging in any direct or indirect transaction with the Iranian government or any person subject to the Iranian jurisdiction, if that transaction would be illicit to any U.S. person or entity. The ITRA statute therefore extended the regulations under which U.S. entities were subject to foreign entities who were controlled by a U.S. person (Carter and Farha 2013: 911-912).

The examples of U.S. legal statutes that impose restrictions on foreign entities is exhaustive. For instance, examine Iran. There is IFCPA Section 1244 which states that

> "the President shall prohibit the opening, and prohibit or impose strict conditions on the maintaining of a correspondent account or payable-through account by a foreign financial institution that the President determines knowingly...conducts or facilitates a significant financial transaction for the sale, supply, or transfer to and form Iran of goods or services" which are "used in connection with the energy, shipping, or shipbuilding sectors of Iran." (Carter and Farha 2013: 912)

Other activities that would involve a foreign entity knowingly engaging with a designated entity are covered in Section 1245, which specifies the sale or supply of certain materials to or from Iran, Section 1246 specifying the provision of insurance or underwriting for sanctioned activities or persons, and 1247, which covers the facilitation of financial transactions by Specially Designated Entities (SDN's). Furthermore, Sections 1244-46 also specify that the President is required to impose five or more of the list of twelve possible penalties as described in the Iran and Libya Sanctions Act of 1996, some of which include prohibitions on contracts with the U.S. federal government, U.S. persons investing in or purchasing large quantities of equity or debt, and on any transfers of credit or payments between financial institutions where the transfers would be subject to U.S. legal jurisdiction and involved in the interest of a sanctioned entity (Carter and Farha 2013: 912-913). Even when Iran tried to turn to Asian markets and the GCC as a result of the U.S. and European sanctions, the U.S. exerted pressure on Asia and the GCC to dissociate themselves from Iran, which was effective (Habibi 2008: 5). The totality of the U.S. sanctions regime and strong influence over foreign entities made it extremely difficult for Iran to participate in international trade.

Going back to the point that Zarate (2009) made, financial sanctions have become multilateral by default due to the interconnectedness of the international financial system, at which the U.S. sits as the head. This is a major factor contributing to its strong influence over trade, financial transactions, as well as the powerful position of the U.S. dollar. Additionally, this is also why the U.S. is likely in the most powerful position to be implementing financial sanctions, as isolation resulting from their designation and implementation is total. As Drezner (2011) put it, "Because the United States [is] the epicenter of global finance, international bankers [need] access to U.S. capital markets to conduct international transactions." (101) As such, one major way in which the U.S. maintains its strong grasp over the global financial system is through its control over the avenues of value transfer.

Payment Systems

The dollar is the single most powerful currency in the world. Carswell (1981) stated: "On balance, most observers conclude that the dollar's status as the world's reserve currency has bestowed significant advantage on the United States." (262) When entities are designated, they can no longer engage in dollar transactions, which has a crippling effect, given the fact that the dollar is the world's most important currency, and therefore involved at least at some point in most transactions (Carter and Farha 2013: 909). Being the issuer of the global reserve currency gives the United States much control over international transactions, as well as both U.S. and foreign entities. The dollar provides an avenue through which the United States can exert power and influence over foreign entities. All banking transactions in eurodollars[16] clear through New York. Therefore, a payment from an Iranian dollar account in Paris to an exporter in Germany is made through a payment clearance system in New York, where the Paris bank tells its New York correspondent bank to pay the New York correspondent bank of the German exporter. While banks abroad may hold dollar accounts, the dollars themselves are physically in the United States, either with a U.S. branch of the bank or another U.S. bank with which they hold a correspondent account. These U.S. banks have accounts with the Fed, which give them access to the dollars. Private foreign banks cannot hold accounts with the Fed, and therefore they do not have direct access to dollars. Therefore, the U.S. has the ability to block the use of these cover accounts held at correspondent banks, which are held by all foreign banks that have dollar accounts (Carswell 1981: 250).

Similarly to the example above, value transfers are primarily conducted through wire transfers in today's economy. In wire transfers, the originator instructs its bank to transfer funds from its account to

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[16] Dollar deposits held abroad.

the account of the beneficiary. If the originator and the beneficiary hold accounts at the same bank, then the bank conducts a book transfer by debiting the originator's account and crediting the beneficiary's account (Carter and Farha 2013: 906). However, if they do not hold accounts at the same bank, then one of two things can happen. If the two banks hold correspondent accounts[17] with each other, then the transfer would be conducted using the correspondent accounts. If they do not have correspondent accounts, then they both may maintain correspondent accounts at a third "intermediary bank", where the transfer will occur (Carter and Farha 2013: 906). These correspondent accounts are part of the U.S.'s legal jurisdiction, and therefore would be subject to any sanctions or regulations implemented.

There are also international settlement and communication systems that enable value transfer across the world. Fedwire is a communication and settlement system owned by the twelve banks in the Federal Reserve System. This is where many U.S. banks hold correspondent accounts, and in this case the Federal Reserve Banks would serve the role of the intermediary bank in funds transfers to settle payments. There is also the Clearing House Interbank Payments System, or CHIPS, which serves as the primary domestic electronic funds transfer system in the United States for processing wire transfers in U.S. dollars between international banks and other financial institutions. The Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a communications system, where transfers are directed through SWIFT and then settled through correspondent banking relationships, such as Fedwire or CHIPS (Carter and Farha 2013: 907). The next chapter will discuss the ways in which the U.S. exerted its power through SWIFT in the face of terrorist financing.

About 95 percent of cross-border dollar transactions are settled through CHIPS, where the financial institutions themselves monitor financial transactions, and will report illicit transactions to OFAC (Carter and Farha 2013: 909). For the same reasons why other countries comply with U.S. sanctions, private financial institutions do as well. The U.S. designates governments, corporations, financial institutions, as well as individuals, and therefore the private sector is also careful to make sure that they are abiding by U.S. statutes. This even includes foreign private entities, who are not technically

[17] Under U.S. law, a correspondent account is an account established at a U.S. bank by a foreign financial institution "to receive deposits from, make payments on behalf of [the] foreign financial institution, or handle other financial transactions related to such institution." (Carter and Farha 2013: 906)

part of the U.S.'s legal jurisdiction. If OFAC finds that a certain entity has violated its sanctions, it may issue a cautionary letter, impose civil penalties, or even pursue criminal prosecution. OFAC has instituted hundreds of millions of dollars in civil penalties on U.S. and foreign financial institutions and companies for violating its sanctions. One such example is Deutsche Bank, as mentioned earlier. Its resulting fines totaled at least $200 million (Protess and Eavis 2015) Designation by the United States as a result of involvement in illicit transactions can mean a financial death, and therefore private institutions have a strong incentive to self-police. Even a hint of future designation can be crippling. Before the Treasury had officially designated Banco Delta Asia, the threat of designation alone caused a run on the bank, depleting 34 percent of its deposits within days (Carter and Farha 2013: 910). Many private sector entities have implemented sophisticated OFAC screening software in order to keep their monitoring systems as robust as possible (Carter and Farha 2013: 909).

3.6: Concluding Remarks

Carswell (1981) said that in order to successfully implement financial sanctions, multilateral cooperation is necessary (264). Going back to Zarate (2009) once again, he said that financial sanctions are multilateral by nature, due to the involvement of the international financial community in policing transactions and other activities occurring within the international financial system. However, are sanctions multilateral by nature, or is it forced? What if another country imposed financial sanctions. Would those sanctions be adhered to by the international financial community in the same way as sanctions implemented by the United States? If the answer is no, which it more than likely is, then sanctions may be multilateral not necessarily due their inherent nature, but rather because foreign entities may not have another choice. Going back to Pistor's argument, we observe that the law bends for powerful apex countries, and it is clear from this chapter that the U.S. has the power to bend the law across the globe, perhaps coercing multilateral cooperation with its sanctions regimes. This legal power stems from the spatial hierarchy of the dollar, whose influence spreads far beyond the U.S.'s legal jurisdiction, effectively expanding it. No one wants to risk losing access to U.S. markets, the dollar, and the international financial system as a whole.

Are countries concerned about this power, and are they doing anything to remove the United States from this special position? Perhaps they are to an extent. For instance, after having seen the power of the United States in sanctions implementation during the Iranian case, the U.S.S.R. made sure to owe more to U.S. banks and corporations than the aggregate Soviet deposits and assets under direct U.S. control. Countries also withdrew from some of their dollar assets. For instance, in 1979, about $16.5 billion of the $40 billion increase in OPEC claims against the international banking system was held with U.S. banks. In 1980, only $1.1 billion of the corresponding $44 billion increase was held with U.S. banks. Thus, new OPEC dollar deposits were being made with foreign banks. While we cannot draw the conclusion that this was a result of the 1979 sanctions episode in Iran, the timing aligns and it is a possible motive (Carswell 1981: 260-261, 263). Zarate (2009) also argues that alternate banking outlets, such as China, Malaysia, Russia, Qatar, and Venezuela may rise to the occasion to opposing financial sanctions by assisting designated entities in conducting transactions. This is not necessarily due to their approval of the activities of such entities, but rather as an action that on principle opposes the United States (56).

While Carswell and Zarate bring up interesting points, on the whole it seems as if the international financial community has remained rather passive to the U.S.'s hegemony. Even during sanctions episodes where countries did not necessarily agree with the severity of the regulations imposed, countries not only did not oppose them, but also abided by them as well. Going back to the first point of this chapter, it is important to understand the mechanics of the U.S.'s powerful position in the international financial arena to implement financial sanctions, and it is also imperative that the effects of sanctions as a tool of financial statecraft be understood, as they may have more severe consequences than they were originally thought to have, namely on the general population of the target country.

4. A Taxonomic Approach to Analyzing Institutional Terrorist Financing

"The terrorists are most afraid of you because you go after their money."[18] (Zarate 2013: 78)

This chapter analyzes perhaps one of the most prominent and contemporary forms of financial warfare: the deterrence of terrorist financing in the recent decade. After 9/11, the U.S. made counterterrorism a national and international priority, and a major weapon that emerged was attacking terrorist organizations financially. The Treasury was instrumental in orchestrating the development of these potent weapons, such as targeted asset freezes and designating entities associated with terrorism, and thus this chapter begins with the restructuring of the Treasury after 9/11, and how it went from being irrelevant to national security discussions to a major participant. What follows is an analysis of the mechanisms of terrorist finance, as well as the methods with which the U.S. has decimated the financial infrastructure of terrorist organizations, and made it clear to the entire world that terrorist financing is something it takes very seriously. Given that counterterrorism efforts, especially as a tool of financial warfare, have only been developed in the past decade, there is still much work to be done.

4.1: A Wake-Up Call

Prior to the September 11, 2001 terrorist attacks, the counterterrorism infrastructure in the U.S. federal government, as well as intergovernmental agencies, was drastically underdeveloped, and not fit to take on the sophisticated financial infrastructure of terrorist organizations. Furthermore, in the counterterrorism efforts existing at the time, starving terrorist organizations' financial networks was not a mainstream tool, and thus the U.S. Department of the Treasury, one of whose missions is to protect the integrity of the global financial system, was not a participant in national security discussions. Prior to 9/11, there had been insignificant attempts to deter terrorist activities through financial means, such as in 1996 and 1998, where two attempts had been made to cut of Bin Laden and Al Qaeda's finances, but both were unsuccessful (9/11 Commission Report 2004: 109, 122). The FATF up until this point in time had only focused on money laundering, which is distinct from terrorist financing, and as such the majority of

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[18] Statement by Crown Prince Abdullah of Saudi Arabia to Secretary of the Treasury John Snow in September 2003, when Snow and his Treasury delegation were traveling to Afghanistan.

states had not taken domestic action in the deterrence of terrorist financing (Bantekas 2003: 326). Thus, the pre-9/11 regulatory regime was not designed to detect or disrupt the financial infrastructure of terrorist organizations (Freeman 2013: 21).

However, after 9/11, the previously irrelevant Treasury would become a major participant in national security discussions, as the world, led by the U.S., revolutionized its understanding of the inner workings of terrorist organizations.[19] As intelligence officials began to understand the centrality of money not only in the execution of terrorist activities, but also in uncovering terrorist footprints, financial warfare rapidly became a mainstream tool of national security. In announcing Executive Order 13224 on September 24, 2001, less than a month after the 9/11 attacks, President George W. Bush announced to the world that the United States was going to engage in financial warfare with terrorist organizations, not only stressing it as domestic policy, but an international effort in which it expected full cooperation:

> "We have established a foreign terrorist asset tracking center at the Department of the Treasury to identify and investigate the financial infrastructure of the international terrorist networks...We will lead by example. We will work with the world against terrorism. Money is the life-blood of terrorist operations. Today, we're asking the world to stop payment." - President George W. Bush, Sept. 24. 2001 (Zarate 2013: 29)

As the powers of the Treasury in issues of national security became apparent, its main focus became stopping bad money from infecting the financial system and isolating those who would abuse the system to the detriment of the U.S. (Zarate 2013: 143). Furthermore, the ambiguity in the wording of Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (heretofore known as: Patriot Act), allotted the Treasury even more power in preventing terrorist and other illicit money from entering the global financial system. The Patriot Act gave the Secretary of the Treasury the ability to designate foreign jurisdictions, institutions, types of accounts, and classes of transactions as "primary money laundering concerns". The Treasury was also given the ability to inflict countermeasures against designated entities and urge U.S. financial institutions to implement certain measures to ensure that they do not work with these entities. In delineating the terms of the designation, Section 311 of the Patriot Act broadly defined what could be seen as "risky" to

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[19] Prior to 9/11, the only role the Treasury had pertaining to national security was thwarting counterfeiting operations, as well as traditional money laundering.

the global financial system, and as such the Secretary of the Treasury could make these allegations without solid proof. In a post-9/11 world governed by reputation, amongst both private financial institutions and countries, what the U.S. Treasury said about you could make or break how the world perceived you, and thus this became a formidable weapon. For instance, by 2003, Section 311 had already been used against two jurisdictions--Ukraine and Nauru. The FATF had called for countermeasures against these countries due to their under-regulated financial systems and suspected ties to Russian organized crime. Ukraine responded within a month, enacting money laundering measures, and Nauru even more quickly, within days implementing legislation addressing U.S. concerns (Zarate 2013: 151-153). These designated entities were condensed onto a list known as the Specially Designated Nationals (SDN) list, which is available to the public on OFAC's website. Banks and other private financial institutions constantly monitor these lists, ensuring that they are not working with any of the designated entities, for fear of being put on the list themselves. Being put on the U.S. Treasury's SDN list is a financial kiss of death.

Alongside its power to designate entities based on their engagement in "risky" financial activities, the Treasury also had the power to impose sanctions policy and collect financial intelligence. The development of financial intelligence became a mainstream tool for attacking the inner workings of terrorist activity. Zarate (2013) defines financial intelligence as such:

> "any bit of information--however acquired--that reveals commercial or financial transactions and money flows, asset and capital data, and the financial and commercial relationships and interests of individuals, networks, and organizations. Such information can come in a variety of forms--crumpled receipts found in terrorist safe houses, the detailed ledgers of hawaladars, suspicious transaction reports from banks, and transnational wire transfer records." (Zarate 2013: 46)

Information on the financial networks associated with terrorist organizations could reveal a plethora of vital details such as their location, their sources of money, planned attacks, etc. The major departments within the Treasury that imposed sanctions on designated entities and collected financial intelligence were OFAC and FinCEN. In 2002, the Department of Homeland Security was created, resulting in the transfer of major Treasury departments to Homeland Security, such as the Secret Service, FLETC[20], Customs, and the ATF[21], and along with these departments left key experts as well. However, despite this radical change to the Treasury, under the direction of Juan Zarate, the Treasury proved the relevance of money and finance to issues of national security, and the power behind its growing arsenal of financial weaponry (Zarate 2013: 130-144). The 9/11 Commission Report published in July 2004 conveyed considerable doubt toward the potential for financial warfare as an effective tool to deter terrorist activities, believing that in the future Al Qaeda could potentially break up into smaller self-financing units sustained by legitimate employment or low-level criminal activity. The Report also has individual sections for particular arms of the federal government, including the Intelligence Community, Congress, the Department of State, the Department of Defense, the White House, the Federal Aviation Administration, and the Law Enforcement Community, while the Treasury does not (9/11 Commission Report 2004: 381-383). However, the views expressed in the 9/11 Commission Report were likely very reflective of perceptions toward the Treasury in the federal government during that time, given that the Treasury was significantly down-sized to the benefit of Homeland Security, and the Treasury's history of never having had relevance to national security issues.

No only did the U.S. have an immediate response to 9/11, the United Nations did as well. Two weeks after 9/11, the UN Security Council passed Resolution 1373, which was sponsored by the United States. Resolution 1373 criminalized all activities classified as terrorist financing, obliged states to freeze all funds or financial assets of persons and entities that are directly or indirectly used to commit terrorist acts or that are owned and controlled by persons engaged in or associated with terrorism, obliged states to prevent their nationals (including private financial institutions) from making such funds available by imposing strict client detection measures, suspicious transaction procedures, and subordination to other intergovernmental institutions in order to receive the names of designated terrorist organizations or individuals, and imposed substantive and procedural criminal law measures at the domestic level, including an obligation to cooperate in the acquisition of evidence for criminal proceedings (Bantekas

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[20] Federal Law Enforcement Training Centers.

[21] Bureau of Alcohol, Tobacco, Firearms, and Explosives.

2003: 326). A similar resolution had been proposed in 1999 but most states did not ratify it. This time, despite the fact that the measures were more strict, states were fast to ratify it, including states that had been accused of fostering terrorism in the past, such as Sudan, Iran, Libya, and Iraq. Furthermore, Resolution 1373 made no reference to Al Qaeda, suggesting that in sponsoring the resolution, the U.S. took advantage of the international sentiment due to the circumstances of the time by bringing into effect measures that the Council and states would not have adopted under other circumstances (Bantekas 2003: 326). In addition, in October 2001, the FATF expanded its mandate to cover terrorist finance (ACAMS 2012: 15). Soon after, it published its "Special Recommendations on Terrorist Financing", which would commit members to ratify counterterrorism treaties, criminalize terrorist financing, freeze and confiscate terrorist assets, report suspicious transactions, provide related assistance to other countries, impose anti-money-laundering requirements on alternative remittance systems, strengthen customer identification measures in international and domestic wire transfers, and ensure that nonprofit organizations cannot be misused to finance terrorism (Bantekas 2003: 327). The "Special Recommendations on Terrorist Financing" were supposed to be adhered to in conjunction with the FATF Forty Recommendations on Money Laundering to ensure that states were taking the necessary measures to suppress terrorist financing (FATF IX Special Recommendations 2001: 2).

Chart 3.2.1: Money Laundering vs. Terrorist Finance

	Money Laundering	*Terrorist Financing*
Motivation	■ Profit	■ Ideological
Source of Funds	■ Internally from within criminal organizations	■ Internally from self-funding cells (increasingly centered on criminal activity) ■ Externally from benefactors and fundraisers
Conduits	■ Favors formal financial system	■ Favors cash couriers or informal financial systems such as hawala and currency exchange firms
Detection Focus	■ Suspicious transactions, such as deposits uncharacteristic of customer's wealth or the expected activity	■ Suspicious relationships, such as wire transfers between seemingly unrelated parties
Transaction Amounts	■ Large amounts often structured to avoid reporting requirements	■ Small amounts usually below reporting thresholds
Financial Activity	■ Complex web of transactions often involving shell or front companies, bearer shares, and offshore secrecy havens	■ No workable financial profile of operational terrorists exists, according to U.S. 9/11 Commission
Money Trail	■ Circular — money eventually ends up with person who generated it	■ Linear — money generated is used to propagate terrorist group and activities

Source: James R. Richards

Source: Association of Certified Anti-Money Laundering Specialists

4.2: Following the Money

Terrorist financing has often been described as "reverse money laundering". This is due to a major distinguishing element between terrorist financing and money laundering (see Chart 3.2.1). In money laundering, illicit funds are disguised as legitimate funds through various financial maneuvers, whereas in terrorist financing, funds are usually derived from legitimate sources and then used for illegitimate purposes.[22] Terrorist funds are mainly used for organizational expenditures, such as salaries for jihadists, training camps, airfields, vehicles, arms, development of training manuals, as well as payments to the families of current and deceased operatives (9/11 Commission Report 2004: 171). Terrorists also typically move money around in small amounts at a time, allowing it to move through the financial system without attracting the unwanted attention of financial institutions, and in addition, terrorist funds are usually commingled with money raised for legitimate causes (Zarate 2013: 21). As such, private terrorist money can be divided into two categories with respect to its origin: legitimate funds and unlawful funds. Legitimate funds include donations, money from charities or charitable trusts, and proceeds from other forms of fundraising (Bantekas 2003: 316). While some funds are used for illicit activities, such as paying a terrorist sleeper cell, some may also be used for legitimate purposes, like feeding orphans (Zarate 2013: 22). Unlawful funds are associated with some type of illegal activity that includes a criminal act under both national and international law, such as drug trafficking, money laundering, smuggling, and illegal arms trade (Bantekas 2003: 316). Given that terrorist financing has the added component of legitimately-sourced funds, pre-existing money laundering detection techniques are insufficient, and therefore finding ways in which to accurately detect terrorist financing is very difficult. Going forward for the U.S., this would require tough negotiations and collaboration with other governments as well as private organizations, for instance the government of Saudi Arabia and the international financial messaging service SWIFT, both of which will be described in detail later in the chapter. In April 2002, the FATF published common methods used in terrorist finance to assist financial institutions in deciding which transactions to be suspicious of. Some examples include the use of an account as a front for a person with suspected terrorist links, appearance of an accountholder's name on a list of suspected terrorists, frequent large cash deposits in accounts of non-profit organizations, high

[22] Some common methods used to launder money include cash smuggling, structuring, purchase of monetary instruments, wire transfers and the use of credit or debit cards (ACAMS 2012: 98).

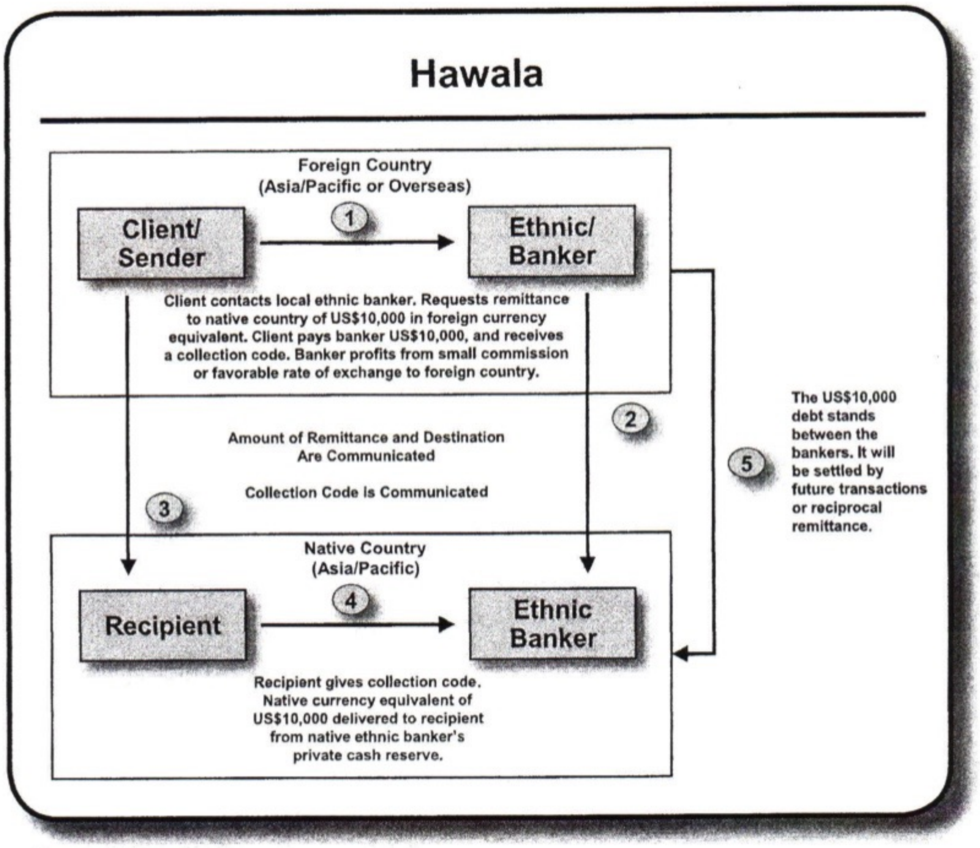
volume of transactions in the account, and lack of a clear relationship between the banking activity and nature of the accountholder's business (ACAMS: 2012: 103).

While many of the methods of terrorist financing are known, actually identifying transactions as ones relating to terrorist finance is extremely difficult. Two common methods of terrorist financing, informal value transfer systems (IVTS) and charities make detection of suspicious transactions very challenging. These two approaches to terrorist finance will be discussed at greater depth to demonstrate the mechanics of money movement throughout terrorist networks, and not only how intricate these networks are, but also how they are unique compared to the traditional financing of criminal activities and money laundering.

Hawala

An informal value transfer system is defined as any system, mechanism, or network of people that receives money for the purpose of making the funds for an equivalent value payable to a third party in another geographic location, whether or not in the same form (ACAMS: 2012: 3). Throughout the world, there exist many IVTS's, such as *fei qian* (飞钱) in China, *hawala* in the Middle East, *hundi* in India, and the *Black Market Peso Exchange* in South America. In IVTS's, money is not physically transferred, but instead it is *value* that is transferred. The specific IVTS that this paper will be discussing is hawala, whose network extends throughout the Middle East, Afghanistan, and the Indian Sub-Continent. In hawala, value is transferred between *hawaladars*, or brokers/couriers in the hawala system, who communicate amongst one another. Hawaladars use their own accounts to move money internationally for third parties, who are usually immigrants or visiting workers sending small sums to their homeland to avoid bank fees for wire transfers. For instance, if an individual is working in the United States, but wants to send money back home to his family in Pakistan, they can use hawala by contacting a hawaladar in the United States. The individual gives the hawaladar the money that they want transferred to their family back in Pakistan, and the hawaladar calls up another hawaladar who is located in Pakistan. The hawaladar in Pakistan then takes the money out of their account and sets up a meeting with the people who receive the money to give it to them. Thus, no money has been physically moved in this transaction, only value.

Chart 3.2.2: Hawala



Source: Interpol Source: Association of Certified Anti-Money Laundering Specialists

Furthermore, it is simple to convert between currencies as well, with the individual in the U.S. being paid in dollars, and his family possibly receiving it in the Pakistani rupee. At another time, the hawaladars will settle their accounts, given that the hawaladar in the U.S. now owes the hawaladar in Pakistan the amount of money that has been transferred. However, hawaladars usually also run other businesses, and therefore that is usually one of the ways in which they pay other hawaladars. For instance, a hawaladar might ship goods to another hawaladar at an undervalued or overvalued cost. In the example of the hawaladars in the U.S. and Pakistan, the U.S. hawaladar might ship the Pakistani hawaladar goods at a reduced price, or the Pakistani hawaladar might ship goods to the U.S. hawaladar at a higher price in order to settle their accounts. Thus, funds associated with hawala can simply look like a business transaction (ACAMS 2012: 104; see chart 3.2.2).

Hawala leaves little to no paper trail. Hawaladars do not usually document individual transactions, but instead just document the amount owed to other hawaladars. Prior to 9/11, Al Qaeda moved much of its money around via hawala, using about a dozen trusted hawaladars who likely knew the nature of the transactions they were facilitating (ACAMS 2012: 106). For example, Al Barakaat was an international remittance system founded in 1986 for Somali expatriates to send remittances to Somalia. At the time, Somalia had no formal banking system and a nonexistent governance structure, allowing Al Barakaat to grow into a large international network of remitters, hawaladars, and money service businesses in over forty countries including the U.S. and the EU. Millions of dollars were being moved throughout the network yearly. However, intelligence analysis revealed that Al Barakaat was being controlled in Somalia by an extremest businessman named Ahmed Jumale, who profited from the system, sending some proceeds to Osama bin Laden and Al Qaeda. Most remitters who used the system were not aware of this, however the entire system was shut down. On November 7, 2001, OFAC designated the entire network, including Jumale, and seized $1.1 million in the U.S. The Treasury said that Jumale had siphoned millions of dollars from Al Barakaat, with about 10 percent of global revenues going to bin Laden and Al Qaeda (Zarate 2013: 37-38).

Due to the intricacy of IVTS networks such as hawala, and their popular use in terrorist financing, the first global hawala conference was held in Abu Dhabi in 2002. This conference served to build awareness on how hawala worked and how countries were addressing issues pertaining to informal money flows. However, the real work of the conference was after it was over, when Zarate led the U.S. delegation in discussions with the central bank governor of the United Arab Emirates, Sultan al-Suweidi, and began to establish guidelines on how to address hawala in the post-9/11 world. The result of these talks was an agreed upon roadmap outlining how the UAE and other countries would regulate hawala (Zarate 2013: 95). It was important that the regulation of hawala was addressed, given that it was, and continues to be, deeply embedded in the culture of the countries it serves, and therefore the possibility of dissipating hawala altogether is nonexistent.

Charities

Al Qaeda and other extremist groups use the Islamic obligation of *zakat*, or charitable giving, as well as their interpretation of obligatory jihad to obtain financing through charity organizations. Given that in many Islamic countries religion is inseparable from the state, *zakat* is not only a religious obligation, but a legal one as well. *Zakat* is therefore collected through a tax on wealth, and is payable on many categories of property, such as savings and investments, produce, inventory of goods, salable crops, and precious metals. The Qu'ran establishes five lawful recipients of *zakat*, one of which is *sabil Allah*, which refers to persons engaging in deeds for the common good of Muslim society. Terrorist organizations have construed the interpretation of *sabil Allah* to include violence against non-Muslim Western societies (Bantekas 2003: 322). Traditionally in the Islamic world, there has been no formal oversight mechanism for donations (9/11 Commission Report 2004: 372). Furthermore, the infrastructure of charities, which usually have operations internationally, provides not only a way to move money easily, but also a way to enlist and transport operatives across the world under the guise of charitable work. As Zarate (2013) said, "Charities might be providing services to widows and orphans, but their funding and recruitment would often send suicide bombers into buses and cafes." (70) Many of the individuals who donate to charities were not aware that the funds they were providing would be used for terrorist activity. Under the facade of a "charitable" or "relief" organization, a terrorist group can openly solicit funding for its operations, taking advantage of *zakat* (Bantekas 2003: 322).

In working to shut down corrupt charities to curtail terrorist financing efforts, the U.S. was aware that they needed to make sure these actions did not give off the perception that they were attacking Islamic charities, but instead attacking the conduits of terrorist financing, some of which were corrupt charities. Thus, in its efforts to shut down certain charities, the U.S. had to make a solid case against them, and have support from other governments. An example of one such corrupt charity was Al Haramain, the largest Islamic charity in Saudi Arabia. Al Haramain had branches throughout the world, including the United States, where they raised money for Islamic charitable causes. However, Al Haramain also served as a platform through which money funding Al Qaeda was transported into places like Bosnia and Indonesia. The head of the organization, Sheikh Aqeel Abdulaziz al-Aqil, seemed aware of this, and fine with allowing it (Zarate 2013: 72). The U.S. wanted to shut down the entire charity, but knew that that would not be accomplished overnight. At first, the U.S. focused on shutting down the most problematic branches of the charity, and getting the Saudi government onboard, which was imperative. After meeting with the Saudi Crown Prince Abdullah on March 11, 2002, Saudi Arabia and the U.S. made the first joint submission to the UN, designating the Bosnian and Somalian branches of the Al Haramain Foundation, and later designating other branches as well as investigating Sheikh Aqeel Abdulaziz al-Aquil. By 2004, the Saudi's shut down all of Al Haramain, and would ultimately prosecute its director for financial crimes (Zarate 2013: 76-77).

It is important to note that for countries such as Saudi Arabia where religion and the state are interconnected, such designations and cooperation are not easy to accomplish. Prior to 9/11 both the U.S. and the Saudi's were aware of the possible ties between Al Haramain and Al Qaeda, however the U.S. and Saudi Arabia were content with not addressing it, given that counterterrorism was not a priority at the time. After 9/11, that changed when the U.S. came to Saudi Arabia asking for cooperation, and likely was not going to take "no" for an answer. At first, the Saudi's hesitantly agreed to quietly cooperate, not having the infrastructure to address terrorist finance nor accepting the U.S.'s offer to have officials trained in this area. However, after an attack on Saudi soil by Al Qaeda in the community of Riyadh in 2003, the Saudi's were onboard. They passed new anti-money-laundering legislation and took drastic measures to deter terrorist financing within their borders, such as taking away collection boxes from mosques and shopping malls. For a government deeply rooted in religion, these were huge measures to take. Governments were not the only ones taking counterterrorism measures to cooperate with the U.S., private institutions were as well.

Terrorist Finance in U.S. Private Financial Institutions

U.S. private financial institutions have played a role in terrorist finance, whether or not they were aware of it at the time. Major U.S banks were instrumental in the 9/11 plot, being the avenue through which money was transferred to the hijackers once they were on U.S. soil. After 9/11, the federal government enforced stricter regulations on private financial institutions, as well as harsher consequences for association with terrorist finance to ensure that private financial institutions in the U.S. would not be vehicles for terrorist finance.

The 9/11 hijackers opened twenty-four bank accounts at four different U.S. banks. These accounts were opened with cash or cash equivalents of about $3000-5000, with the identification used to open the accounts being visas issued through foreign governments with addresses that were not permanent and changed frequently. The accounts were opened within thirty days after entry into the U.S., and all accounts were normal checking accounts with debit cards, with some being joint accounts. No savings accounts or safe deposit boxes were opened. They were all opened at large well-known banks, with twelve of the hijackers opening accounts at the same bank. The hijackers deposited money into the U.S. accounts via wire transfers and deposits of cash or travelers checks brought from overseas. Some also kept foreign accounts in Germany and the UAE. The entire 9/11 plot cost Al Qaeda between $400,000 and $500,000, $300,000 of which passed through the hijackers' accounts in the U.S. Transactions were kept to amounts small enough so that they would not need to be reported or arouse unwanted suspicion, and after deposits were made withdrawals were made immediately, with numerous attempts made to withdraw cash in excess of the debit card limit. Many balance inquiries were made as well (ACAMS 2012: 100-101). The hijackers had student status, so it appeared as if they were receiving money from their parents to finance their studies, which made detection on the basis of the transactions, which did not exceed $10,000 each time, extremely difficult (Bantekas 2003: 321).

To be sure, the 9/11 plot has not been the only terrorist activity in which U.S. private financial institutions have had involvement. When the U.S Treasury, the rest of the federal government, and intelligence community were evaluating their counterterrorism efforts after 9/11, this was something that was abundantly clear, and needed to be addressed. As such, there was a major crackdown on private financial institutions, and reputation was the major element at stake. As stated earlier, no financial entity wanted its name to be listed on OFAC's SDN list, the financial black list compiled by the Treasury available to the public. In order to avoid the crippling effect of the negative publicity associated with being an institution affiliated with terrorist financing, financial institutions needed to take certain measures to ensure to the best of their ability that they were not working with terrorist organizations. For banks that were more lax on implementing these measures, even prior to 9/11, the consequences could be severe. One such example that demonstrates how seriously the U.S. took counterterrorism efforts, or lack thereof, in private financial institutions is Riggs Bank.

Riggs Bank was a well-known, Washington, D.C.-based bank founded in the 1800's. Riggs Bank provided financial services to a wide range of distinguished international clientele, namely foreign diplomats and embassies. While Riggs ran an extremely successful banking business, the usual head nods and winks between private bankers and privileged clientele were no longer acceptable in the post-9/11 world, especially when those privileged customers were associated with terrorism (Zarate 2013: 149). Under the Bad Bank Initiative, on May 13, 2004, the Office of the Comptroller of the Currency (OCC) and FinCEN fined Riggs Bank $25 million for willful violations of suspicious activities and currency transaction reporting, as well as for failure to establish an adequate anti-money-laundering system. The business Riggs ran working with foreign diplomats and embassies was extremely high-risk, and on top of that Riggs did not do much to regulate these accounts and monitor them closely to prevent illicit financing (Zarate 2013: 148-149). Riggs worked with many PEP's, or politically exposed persons, such as Augusto Pinochet, former President of Chile, and Teodoro Obiang, the President of Equatorial Guinea (ACAMS 2012: 20). Riggs had such a close relationship with Pinochet that bankers would fly to and from Chile on Pinochet's private jet, taking hundreds of thousands of dollars worth of cashiers checks to Pinochet, which later were discovered as proceeds of corruption. In addition, Riggs also transported money through real estate transactions that appeared to be structured in such a way as to avoid linking them to Pinochet (ACAMS 2012: 36). In addition, Riggs failed to file suspicious activity reports on $98 million worth of transactions, as well as failed to detect and report suspicious cash, monetary instrument, and wire activity by the Saudi and Equatorial Guinean governments. For instance, there were cash payments made from the Saudi embassy to Saudi citizens out of its account at Riggs Bank. These payments included payments to Khalid al-Mihdhar and Nawaf al-Hazmi, two of the 9/11 hijackers (Zarate 2013: 85).

While a $25 million fine seems small compared to Riggs' assets totaling $5.8 billion, in the process of being publicly designated by the Treasury, its entire reputation was destroyed and it was forced to close many of its accounts for embassies in Washington, D.C. This triggered a crisis as embassies scrambled to find new banks to take their accounts. Riggs was bought by PNC Bank, and other banks were forced to enter the business of banking foreign diplomats and embassies (Zarate 2013: 150). This business is extremely low-profit and high-risk, and as such U.S. banks were not willing to enter the business, which would effectively place them in the position to risk enduring the same fate as Riggs. However, Bank of America, CitiBank, and HSBC ended up taking on clients. Overtime, Citibank and HSBC left the business, and Bank of America's Global Government Division based in Washington, D.C. is now the major banking entity for embassies and foreign diplomats. Today, Bank of America's Global Government Division is very careful in assessing the risk associated with its international clientele, and the cost of borrowing money for riskier clients is much higher. Risk in this business is associated with the state of political unrest associated with a country, as well as their ability to pay.

For financial institutions that rely on the proceeds of crime, the consequences include loss of profitable business, liquidity problems through withdrawals of funds, termination of correspondent banking facilities, investigation costs and fines, asset seizures, loan losses, and reduced stock value of the financial institution (ACAMS 2012: 21). Therefore, since 9/11, banks have become extremely reputation-conscious, and willing to completely cut off ties with rogue individuals and regimes on their own, without outside coercion. Access to the global financial system is essential for banks, and at the head of the global financial system lies the United States, namely New York. With New York being the most important financial center in the world, and the dollar serving as the global reserve currency as well as the dominant currency for trade, actors in the global financial system have been extremely careful to act in accordance with American regulations (Zarate 2013: 150-151). By as early as January 2002, the world's largest banks met and discussed terrorist financing, and updated the previously established Wolfsberg Principles, which addressed money laundering, to encompass terrorist financing as well. The "Wolfsberg Statement on the Suppression of the Financing of Terrorism" acknowledges that terrorist funds "do not necessarily derive from criminal activity", and that terrorism can be defeated only by global cooperation between state entities and banks (Bantekas 2003: 331-332).

4.3: Leading the Global Effort Against Terrorist Financing

> *"...because the United States is the world's largest economy, we are frequently put, whether we like it or not, in the position of global financial leadership. Take a simple example. After a year and a half on the job, I began to notice that the World Bank's operating budget was growing very rapidly, and I raised my concerns with my G7 finance colleagues. Of course, as good allies they agreed to help and support me, but their reaction was telling: 'It's about time you raised this. We always expect the United States to watch over operations like this.' Until these circumstances change, the United States will continue to be at the demanding center of global financial policymaking, and the dedicated work of the global financial warriors at the U.S. Treasury will remain crucial to global stability."*
>
> *- John B. Taylor, Former Under Secretary of the Treasury for International Affairs, 2001-2005*
>
> (Taylor 2007: 310)

In his 2016 State of the Union speech, President Barack Obama stated that "...when it comes to every important international issue, people of the world do not look to Beijing or Moscow to lead. They call us." President Obama in the same speech called the United States "the most powerful nation on Earth" and former President Bill Clinton called the U.S. an indispensable nation. As such, in fighting terrorism on the financial front, the U.S. led the world in developing measures to detect terrorist finance, as well as in cooperation against terrorist financing. In countries were cooperation was possible, the U.S. established it through diplomacy. In other countries where cooperation was not possible, perhaps due to corrupt regimes hostile to the U.S., the U.S. used its power of designation. The example of the Saudi Arabia/U.S. cooperation is particularly striking, due to the cultural barriers in Saudi Arabia that had to be overcome in order to financially deter terrorist activity.

Saudi Arabia - Financial Diplomacy

Saudi Arabia has been described as a "problematic ally" where "al Qaeda raised money directly from individuals and through charities" and "the society that produced 15 out of the 19 hijackers." (9/11 Commission Report 2004: 371) Prior to 9/11, the conditions in Saudi Arabia were ideal for terrorist finance. In the 1980's a network of donors, charities, and sponsors called the "Golden Chain" was developed to help the Afghan mujahideen and foreign Islamic fighters in resisting the Soviet invasion of

Afghanistan. This network still exists, and violent jihadist causes have been taking advantage of it, for instance in fighting the Russians in Chechnya, the Israeli's in the Palestinian territories, and the Americans in Afghanistan. Furthermore, when the House of Saud established its rule over the Arabian Peninsula in 1932, it made an agreement with the ultraconservative Sunni clerical establishment, allowing the Saudi regime to maintain power and legitimacy. As "Keeper of the Two Holy Mosques", the Saudi monarch was not only the head of state, but also the guardian of the two holiest sites in Islam, Mecca and Medina. Furthermore, the Saudi regime was committed to an extremist form of Sunni Wahhabi Islam, and thus this was a major part of Saudi culture. Given that the Saudi regime was obligated to promote this type of Islam, much of its money circulated around the world to create religious centers and mosques to export Islamic scholars who reinforced this extremist form of Islam. Al Qaeda took advantage of this, using the Saudi-funded Wahhabi institutions as centers for Al Qaeda operatives and fundraising (Zarate 2013: 68-69; 9/11 Commission Report 2004: 52). Furthermore, terrorist groups used the Hajj, the world's largest annual migration, to transport money from donations out of Saudi Arabia and into the rest of the world. Given the massive volume of people taking part in the Hajj, Saudi officials could only do so much to root out the individuals engaging in terrorist financing activities amongst the rest of the masses. When the Americans asked the Saudi regime to deny access to Mecca by pilgrims who also were potentially affiliated with terrorist fundraising, the Saudi's refused (Zarate 2013: 71). Until 9/11, many Saudi's would have seen the government regulation of donations as an interference with their practice of Islam (9/11 Commission Report 2004: 372).

The Americans knew that they needed to meet with the Saudi regime and establish a relationship of cooperation on the subject of terrorist financing. Saudi Arabia was clearly a hot spot for terrorist activity, and the U.S. knew that without Saudi Arabia's cooperation, attacking the financial infrastructure of terrorist organizations would be much more difficult. The charities associated with the Golden Chain needed to be shut down, and individuals in Saudi Arabia with suspected ties to terrorism needed to be monitored closely. Given the interconnectedness between religion and the state, the U.S. knew that Saudi Arabia would be hesitant on certain measures, namely those pertaining to Islamic charities, and that the prosecution of rogue individuals in Saudi Arabia was less about punishment and more about transforming internal support for extremist causes into support for the government (Zarate 2013: 72). However, the U.S. wanted quick action, and the Saudi's also knew that they had to cooperate with the U.S., given that it would have a negative impact on their global reputation, as well as their relationship with the U.S., if they continued to allow terrorist financing happen within their borders without doing anything to stop it. Furthermore, the Saudi's and the U.S. had a history of friendly relations, likely due to common interests against the Soviets during the Cold War, the Americans needing Saudi oil to stabilize the supply and price of oil in world markets, and the Saudi dependence on the U.S. for protection against foreign threats (9/11 Commission Report 2004: 372). This worked in the U.S.'s favor in conjunction with a strategic error made by Al Qaeda in the May 2003 bombing of Riyadh, resulting in Saudi Arabia giving the U.S. its full commitment to fighting against terrorist financing. Thus, a constructive relationship was built between the U.S. and Saudi Crown Prince Abdullah, who cooperated in the shutdown of Al Haramain and took terrorist financing very seriously. In addition, Prince Muhammad bin Nayef, the deputy interior minister of Saudi Arabia, made examples of Al Qaeda supporters within the Saudi court system, and in addition established a rehabilitation program for Al Qaeda operatives, where they would be "socially and theologically deprogrammed" and were given wives and homes, so that they could be successfully reintegrated into Saudi society (Zarate 2013: 77).

Despite many claims made that Saudi Arabia had played a major role in the 9/11 plot, the U.S. intelligence community confirmed that this was not the case.

> "It does not appear that any government other than the Taliban financially supported al Qaeda before 9/11, although some governments may have contained al Qaeda sympathizers who turned a blind eye to al Qaeda's fundraising activities. Saudi Arabia has long been considered the primary source of al Qaeda funding, but we have found no evidence that the Saudi government as an institution or senior Saudi officials individually funded the organization. (This conclusion does not exclude the likelihood that charities with significant Saudi government sponsorship diverted funds to al Qaeda.)"
> (9/11 Commission Report 2004: 171)

Although Saudi Arabia had been a "fertile fund-raising ground" for Al Qaeda, by 2007 the amount of Saudi funds that found their way into the hands of Al Qaeda had greatly decreased, and the area of counterterrorism remained a consistent area of cooperation between the U.S. and Saudi Arabia, despite tensions from other sources. The U.S. and Saudi Arabia have had mutual recriminations, such as

Americans continuing to see the Saudi's as enemies, and the Saudi government as one that oppresses women, and dominated by a wealthy elite. Furthermore, Americans disagree with the strong Anti-Semitic and anti-American sentiment in Saudi schools and mosques. On the other end, the Saudi's saw the U.S. as aligned with Israel in a conflict in which they strongly sided with the Palestinians, and many in Saudi Arabia remained in denial of terrorist activity within their borders after 9/11, often not responding to U.S. requests for help. However, after the 2003 Riyadh attacks made it apparent that terrorism was a major threat to Saudi Arabia, they were quick to become fully engaged in the U.S.-led counterterrorism efforts (9/11 Commission Report 2004: 374). Financial diplomacy would become a useful tool for the U.S. as it led counterterrorism efforts across the world (Zarate 2013: 90; 9/11 Commission Report 2004: 171). .

SWIFT

When the Treasury became engaged in financial warfare after 9/11, they quickly realized that locating sources of terrorist finance is like finding a needle in a haystack. As can be seen with hawala, charities, and seemingly normal transactions conducted at financial institutions, terrorists are extremely effective in covering up their money and its movements. Thus, the Treasury needed something more potent on its side in order to be able to track terrorist financing.

The Society for Worldwide Interbank Financial Telecommunication, or SWIFT, is a financial messaging service for financial transactions communicated between member banks. This type of communication forms the backbone of the formal financial system (Zarate 2013: 39). SWIFT practically has a monopoly over this type of financial communication, and thus is used daily by thousands of institutions around the world. SWIFT would provide the financial intelligence that the U.S. required, given that the financial messaging traffic is broken down into data fields with specific information including the banks involved, accountholders, amounts transferred, dates and times of transactions and transfers, and contact information (Zarate 2013: 50). The U.S. wanted access to this database, however SWIFT is a private company and upholds an apolitical stance. As such, when the U.S. had attempted to have access to SWIFT's information, as the Justice Department had attempted in the 1980's, SWIFT had denied them every time.

This time would be different. The Treasury was in a state of financial war, and it needed SWIFT to cooperate. Thus, when Aufhauser and O'Neill opened the meeting with the CEO of SWIFT, Leonard Schrank, Aufhauser bluntly stated, "I want your data." (Zarate 2013: 52) No would not be taken for an answer, and it was not. The meeting concluded with an agreement where the U.S. would have access to SWIFT data, so long as certain protocol was followed. Despite the fact that SWIFT is apolitical, it agreed to work with the U.S. and possibly risk criticism from member banks, and even their reputation. It is important to ask whether SWIFT would have taken this risk to work with any other country, and the answer is likely no.

A Financial Blacklist

In addition to having access to SWIFT's data, OFAC became even more powerful through other means as well. The most potent weapon in its arsenal was not its ability to freeze assets or collect intelligence, but instead its ability to designate entities and bar them from the U.S. financial system. OFAC's SDN list is publicly available on its website, and financial institutions are constantly checking it to ensure that they are not working with any designated entities, for fear of being designated themselves. Being barred from the U.S. financial system means not having access to the principal capital and banking market worldwide. Having access to the New York financial markets and the dollar allows access to the global financial system as a whole (Zarate 2013: 24-26). Thus a vicious cycle is created when an entity is placed on the SDN list. Other financial institutions stop working with that entity for fear of being designated themselves, effectively blocking the designated entity from the financial system. The sophistication in this tool is that OFAC does not even have to do all of the work, private financial institutions self regulate, given that the consequences of designation are so severe. Reputational risk became a major point of concern for private financial institutions, and was further exacerbated by the fact that an institution could be designated even if they were not aware that they were working with an entity tied to terrorist financing. A clear message was sent by OFAC's SDN list: if you support terrorism, you will be next (Zarate 2013: 72) Strict compliance standards were established, such as increased suspicious transaction reports and "know your customer" policies.

As Zarate (2013) stated, the color of money had changed (90). It was tainted by terrorist finance which was a separate beast from traditional money laundering because it did not simply lurk in the shadows of the legitimate financial system like money laundering did, but instead was directly engaged in it, entering the global financial system and moving through it on the back of legitimate finance. Banks became the guardians of the financial system because they had to, because if they were caught working with any entity associated with terrorism, it would mean a possible death sentence. Licenses could be pulled by the U.S. and New York banking authorities. No one wanted to risk that.

4.4: Concluding Remarks

By the time Osama bin Laden was killed in May 2011, Al Qaeda's old financial networks had been decimated, and Al Qaeda's core was begging for money from its affiliates and donors, as well as trying to find new ways to raise money. Saudi Arabia and other countries were taking the issue of terrorist finance very seriously, and it was showing (Zarate 2013: 90). In 2012, terrorist organizations began using kidnapping for ransom as a way to raise funds to keep their organization going, which reflects the state of desperation they were in, without donors and without easy access to the global financial system (Council on Foreign Relations 2012). The Treasury's word can move markets because everyone cares about what the Treasury says. Banks, foreign finance ministries, and central banks well outside of U.S. borders care about what the Treasury has to say. The talking points of Treasury officials are scrutinized and have a major influence in the decision making of financial actors around the world (Zarate 2013: 137). Sitting at the center of the world's most powerful economy and the home of the global reserve currency provides real power and influence.

However, counterterrorism on the financial front still has a long way to go. As Freeman (2013) points out, there is no perfect way to deter all criminal and terrorist finance, and if there were to be one it would most likely also disrupt legal, legitimate transactions as well (22). A major challenge moving forward for the U.S. in financial warfare and intelligence will be facilitating these efforts in such a way that terrorist financing can be detected with more accuracy, without disrupting the workings of the international financial system. The U.S. also should focus on making the risk of detection higher, such as enhancing regulatory compliance at the ground level (i.e. airports, banks, non-banking financial institutions), while not disrupting the everyday activities of the general population, as well as improving international cooperation (Freeman 2013: 22).

In his book *The Dispensable Nation* (2013), Vali Nasr states:

> "American leadership is still critical to the stability of the world and the health of the global economy--to expansion of trade and the continued development and prosperity of nations. There is no other power today that could play America's role on the world stage or is willing to step into America's shoes. Nor would the world be better off were that to happen, or even if any and all of the rising BRIC nations and those following in their footsteps tried their hands at it. The world America has built still needs America to lead it. America remains the world's pivotal nation." (252)

While this is a strong statement, it very likely is true. As the sole issuant of the dollar, the global reserve currency, and a powerful tool within itself, the U.S. holds tremendous economic power, which in turn yields geopolitical power. The multinational spatial influence of the dollar places the U.S. in a position of financial hegemony, and thus financial authorities in the U.S., such as the Treasury, have a strong say in international financial affairs. Anyone who wants access to the international financial system listens to what the Treasury has to say. It was through this power and influence that the United States was able to mobilize the world in its post-9/11 counterterrorism efforts. Given the underground nature of terrorist finance, the U.S. needed to exercise power in innovative ways in order to be able to gain intelligence on terrorist financial activity, which is exactly what the U.S. did through SWIFT, the SDN list, etc. So long as the U.S. remains a monetary and economic hegemon, it will continue to have this role in world affairs, and be the most powerful nation in implementing tools of financial warfare. Perhaps noting a significant detail can aid in demonstrating the strong influence the U.S. has on international affairs: counterterrorism only became an international priority after 9/11, despite the fact that terrorist attacks had occurred across the world prior to that event.

Conclusion:

Policy Space

Power in the international arena is largely contingent upon the spatial influence of a country's money, as well as its position in the international financial system. As we have seen, the distribution of currencies is hierarchical, and a currency's location on the pyramid is a direct reflection of the geopolitical power of its issuing sovereign. As such, in implementing tools of financial statecraft, money is a primary instrument, or weapon, that determines whether or not a country will be successful. Firstly, given the relative nature of hegemony, and the fact that hegemonic position is a key factor in financial warfare, it follows that a country must be in a position of higher financial power relative to the country which it is targeting. Financial power can be defined as having a strong, sovereign currency, as well as the macroeconomic flexibility that comes alongside issuing a powerful sovereign currency. Second, a country must have an elastic relationship with the law, as defined by Pistor's legal theory of finance, if it wants to successfully implement financial warfare. A periphery country is by nature subject to the laws in the financial system, which are imposed on them by apex countries. This largely restricts the flexibility in their policymaking decisions, especially relative to the flexibility enjoyed by apex countries, who not only determine the laws, but also have flexible access to them. Thus, apex countries can exercise power in ways that periphery countries cannot.

Going even further, not only does this project speak to the ability of countries to implement financial warfare based on monetary and legal factors, it also concludes that the United States is the ultimate apex country. Not only does the U.S. issue its own sovereign currency, that currency is also the global reserve currency. Being the central authority in the international financial system also allows the United States a large degree of elasticity in its access to the law. During times of crisis, either in the economic sense, as Pistor described, or in a more general sense, such as terrorism, the United States has been able to exercise its hegemonic power in innovative ways. Hence, the policy space enjoyed by the United States is greater than that of any other country. For periphery countries, not only is their policy space restricted by internal factors, for instance not issuing a sovereign currency, but their policy space is also limited externally by apex countries, who impose restrictions on them via the law. For other apex countries, the United States still has greater policy space in comparison. For instance, looking at the European Monetary Union, their policy space is already restricted by the fact that they do not issue their own sovereign currency and are subject to strict limitations imposed by the Maastricht Criteria. Due to this fact, as of right now the EU does not pose a threat to the U.S.'s hegemony. For any country to challenge the U.S.'s position, they need to issue a strong sovereign currency, have the ability to provide liquidity to the international financial system, and they need to hold a significant amount of geopolitical power. As of right now, there do not seem to be any other countries that pose a threat to the U.S.'s hegemonic position based on these factors.

Having the largest amount of policy space is what allows the United States to be in its hegemonic position, especially from a financial perspective. The United States has the greatest flexibility in its access to the law, allowing it to act in innovative ways during times of conflict. According to the theory of financial warfare as presented in this paper, it follows that no other country has the ability to successfully implement financial warfare against the United States, and this claim has be substantiated by real world occurrences. The hegemonic position of the dollar against all other currencies is at the foundation of the U.S.'s superior ability to implement financial warfare. While the power of the sovereign determines the salience of a currency, a currency is also instrumental in expanding the power of its issuing sovereign.

Future Research

This paper does not provide the only theoretical argument on the implications of being the issuer of a global reserve currency. Amongst others, there is an argument known as Triffin's Dilemma that also analyzes this monetary position.[23] Part of the role of being the issuer of the global reserve currency is providing the world with liquidity. As such, a country that issues the global reserve currency necessarily has to run a current account deficit. What Triffin argued was that being the issuer of a global reserve currency effectively narrowed the policy space of a country, as they would have to limit their domestic

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[23] Triffin's Dilemma was developed and presented to Congress in 1960 by a Yale economist named Robert Triffin.

interests in order to provide the world with liquidity. Hence, domestic industries would not be able to be competitive in the international market, and a large deficit would result (International Monetary Fund).

However, according to Triffin, running a large deficit is an unhealthy outcome for a country's economy. Triffin also used the quantity theory of money, positing that the increased amount of dollars in the international financial system would cause inflation in the United States. While many say today that Triffin was correct, this view can be critiqued using Wynne Godley's sectoral balances. The Post-Keynesian interpretation of balance of payments takes a different stance on the issue of public sector deficit, which is that deficit is actually a good thing. Public sector deficit and private sector surplus indicate healthy macroeconomic conditions, while the reverse typically precedes recession.

An interesting project could be developed from this angle of examining the effects on a country of issuing the global reserve currency. Using Godley's sectoral balances, a Post-Keynesian critique of Triffin's Dilemma could be interesting, and provide an new perspective on the benefits reaped from being the issuer of a global reserve currency. Triffin's dilemma disregards the theoretical concepts presented in this project, such as the fact that a state has unlimited access to its own currency. Stemming from the Post-Keynesian interpretation of the origins of money, this research angle on the international monetary system could provide a nice complement to the theory presented in this paper.

Furthermore, the topic of financial warfare is under treated in the economic literature. More empirical work needs to be done to analyze the effects of sanctions on countries, especially as financial sanctions become a mainstream policy tool. Given the underground nature of counterfeiting and terrorist finance, it is difficult to empirically study them, however the conversation surrounding these two topics from a theoretical standpoint has yet to be started in economics. If more minds were thinking about these topics, many interesting ideas could arise.

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