Statement of Jack A. Blum, Esq.

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Before the House of Representatives

Committee on Foreign Affairs, Subcommittee on Terrorism, Nonproliferation, and Trade

And

The House Financial Services Committee, Subcommittee on Domestic and International Monetary Policy, Trade and Technology

Regarding

Isolating the Proliferators and Sponsors of Terror: The Use of Sanctions and the International Financial System to Change Regime Behavior

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My name is Jack A. Blum. I am an attorney in private practice in Washington, D.C. I have worked on international financial issues for most of my career, fourteen years of which was spent on various Senate Committee staffs. I have extensive experience working with private clients and government agencies on issues of money laundering, Patriot Act compliance, foreign asset control issues, and the use of offshore financial havens to evade taxes and hide the proceeds of crime.

Broad embargoes and economic sanctions are not effective against rogue regimes. They will not deter the spread of weapons of mass destruction. They will not change regime behavior. If Congress wants to control the spread of weapons of mass destruction, and modify the behavior of rogue regimes, there are far better and more sophisticated tools available. Before turning to what might work, I will explain why I think embargoes and sanctions do not work.

The growing integration of the world economy allows too many ways to get around an embargo to make it effective in achieving the desired result. In the context of limited enforcement resources to enforce embargoes, an embargo becomes an exercise in punishing the compliant while the brazenly guilty go about their business. If an embargo is effective, the wrong people are usually the victims. In embargoed Iraq, infant mortality rose at the same rate Saddam built new palaces. North Korea built a nuclear bomb and its leader lived well while average people ate grass to prevent starvation.

Quite sensibly the Chinese government limited the impact of the Korean embargo because it feared a flood of refugees coming across the Yalu River. They did not want to take up that humanitarian burden.

The United States has been down the embargo and sanction road many times in the course of its history. The history is as instructive as it is bleak. The first American embargo was of Haiti in 1802. The Southern states were terrified by the slave revolt in Haiti and wanted it crushed. The resulting U.S. embargo succeeded in creating significant economic hardship, but fortunately, did nothing to achieve the intended result – the restoration of slavery on the Island. It can be argued that this early attempt to isolate Haiti was the beginning of that country's road to political ruin.

Some of our other notable embargoes that did not work include the embargo of the shipment of crude oil and petroleum products to Japan in the late 1930's. The embargo posed a dire threat to the Japanese economy which was already suffering as a result of the depression. The Japanese government and its ultra-nationalist military used the embargo as an excuse for invading what is now Indonesia and the Malay peninsula to get control of their oil production. Ultimately, it became the excuse for Pearl Harbor and the excuse of the Japanese leadership used when they were put on trial for war crimes. The embargo did not change the Japanese regime or its policies – it made matters worse.

Some of the more recent efforts at embargoes have been equally counterproductive. Marc Rich assembled one of the world's great fortunes by running the global embargo of petroleum and petroleum products to South Africa and the former Northern Rhodesia. As the world learned after the South African state democratized, shell companies in Caribbean were used to cover the

shipments and bank accounts in secrecy havens were used to cover the money flows and Rich's profits. The oil embargo led the apartheid government into the nuclear business and sent it down the road to proliferation.

The campaigns aimed at disinvestment and broader embargoes on South African goods had the effect of punishing the most liberal, and globally integrated, elements of the South African economy -- the manufacturers and exporters. They were marginalized and ignored by the Nationalists. They were also the ones who were pressuring the government for an end to apartheid even before the embargo was imposed.

There is, of course, the stunning example of the failure of the Cuban embargo. For political reasons, that embargo is the best enforced, and the law and regulations have the most draconian provisions. Cuban embargo enforcement absorbs most of the resources of the Treasury Department's Office of Foreign Asset Control.

As far as I can tell, it has had no noticeable impact on Cuba's political system. Indeed, I submit that the embargo has provided the Cuban Government with an excuse for its total failure at managing the country's economy and has been a political rallying point for the Castro regime. It has also cemented the relationship between Cuba and Hugo Chavez in Venezuela.

The global arms embargo imposed on the former Yugoslavia during the Balkan war was ignored by major arms suppliers who ran Russian military equipment through free trade zones in the Arabian Gulf with impunity. The money to pay for the weapons moved through offshore banks.

My own personal experience with embargoes came when I worked for the Senate Foreign Relations Committee in the late 1980's. We ran hearings on the drug trafficking activities of General Manuel Noriega. We showed that he had been involved with the transshipment of weapons to the Marxists in Nicaragua and the revolutionary groups in Colombia. We also showed that the Cubans used Panama to run Cuban goods, notably seafood into the U.S.

The administration imposed economic sanctions on Panama. After they were imposed, our Subcommittee asked GAO to evaluate the effectiveness of the sanctions. GAO concluded that they were worthless. Various industries had successfully lobbied for exemptions from the regulations. As a result. the regulations were riddled with loopholes. At the same time OFAC did not have any meaningful enforcement capability. The regulations did not change Noriega's policies, and as you will recall, it took an invasion to get him out of office.

The enforcement of sanctions and embargoes fall on OFAC which has been chronically understaffed. It has relied on financial institutions to self report violations and to freeze the funds which are involved in potentially illegal transfers. The bank self-reporting activity and the related seizures and freezes have generated impressive statistics for OFAC, but most of the activity relates to efforts by citizens of the embargoed country who are living here to send money home to their relatives. The serious dollar transactions which finance weapons programs and which would be illegal in the U.S. have moved offshore into foreign banks and alternative clearing mechanisms.

In sum, I believe that broad economic embargoes are dubious. They are impossible to enforce, they impose significant burdens on financial institutions and produce little in the way of results.

When the emotional satisfaction of passing embargo legislation into law fades, government officials and the business community are left with the sober reality that the embargo might harm American interests more than they harm the designated target. This leads to what I call "wink and nod" embargo evasion. Prohibited business gets moved offshore to foreign "independent" companies. U.S. firms change into foreign firms. Commodities are sold and resold to the point where they lose their identity.

In the end, the threat of a negative impact leads to contradictions in policy which would be otherwise inexplicable. For example, the U.S. government believes that it is in the U.S. national interest to have all international oil business done in dollars. If the embargo of Iran is too effective, Iran might well decided to sell its oil for Euros. Thus, the Federal Reserve Bank of New York allows the Iranian Central Bank to clear dollars and helps the independent dollar clearing mechanism put in place by other Asian governments including the embargoed government of Myanmar. All of this takes place "underneath the radar" of Congressional oversight or public opinion.

As an alternative to embargo and sanction legislation I propose the use of already existing Patriot Act tools to identify, trace, and disrupt the trade in nuclear bomb making tools and components, precursor chemicals for chemical warfare agents, and illegitimate trade in biological agents. At this point, there should be special focus on WMD delivery system components and related materials. Even if a country has assembled a bomb, it may still be possible to limit its ability to use it. To accomplish this, I would focus on enforcing customer identification procedures and suspicious activity reporting requirements in connection with commercial transactions. This flow of information, properly utilized, would allow a targeted use of economic and legal tools to limit and disrupt illicit trade.

As part of this approach, I would ask the cooperation of the Financial Action Task Force and the European Union.

The best example of how this approach works is the skillful way the Treasury Department forced the hand of the North Korean government by freezing the assets of the Macau Bank, Banco Delta Asia. The bank was a major mover of U.S. dollars for the North Korean regime. The North Korean funds on deposit there were seized as the proceeds of crime. The relatively limited seizure crippled the ability of the government and its top leadership to keep operating as a criminal enterprise. As a result they came to the negotiating table.

All financial institutions are presently required to file suspicious activity reports. These reports go to FINCEN which in turn passes them on to law enforcement and intelligence agencies. FINCEN and the related FINCEN "customers", especially the intelligence community staffs who track weapons of mass destruction, should be telling financial institutions what kind of financial transactions would be related to the financial side of the WMD business. Those institutions could

then be asked to file reports when they spot the defined transactions. All of this is spelled out in Section 314 of the Patriot Act.

For example, if a manufacturer of centrifuges in Germany receives deposit money from an offshore shell company through a U.S. Bank, the wire should trigger a SAR. If the same manufacturer ships his products to a free trade zone, under a documentary letter of credit the banks involved in the transaction should be required to know their customers, note that this equipment does not go to an end user there, and file a SAR.

Letters of credit are included in suspicious transaction reporting requirements and customer identification requirements, but because the regulations allow institutions to base transaction monitoring on the level of risk, many institutions do not monitor the transactions because they consider commercial trade financing low risk and not worth monitoring.

On the government side of the equation, all of the intelligence people who follow WMD issues should be aware that each movement of goods has a related financial transaction. Each payment of a bribe for information or access to prohibited material leaves a financial trail. The intelligence analysts should be trained to follow the money trail.

Inasmuch as most of the supplies used to manufacture WMD come from countries with export controls, the export control machinery can be used to shut down the shipments and punish the suppliers and the shippers.

Existing law is more than adequate to deal with the problem of proliferation. The issues are intelligent use of the information generated by the present system and intelligent use of the tools available to freeze funds and control transactions. However emotionally satisfying new legislation might be, it will not make much difference and it will impose costs and an additional burden on financial institutions.

Finally, I urge you to consider the problem of "free trade zones." These zones make their living off the repapering of cargoes, re-invoicing to avoid customs and taxation, and as the perfect place to transship weapons of all kinds. In a world terrorist threats, nuclear proliferation, potential dirty bombs and dangerous cargoes, it seems mad to leave large holes in the system. If the point of a free trade zone is to avoid taxation on re-manufacture, or to break bulk on a shipment, there is no reason incoming and outgoing cargoes cannot be inspected and documented. It is almost as if these zones were invented to make mockery of the global regimes to control the weapons trade and to limit proliferation.