Testimony before the U.S.-China Economic and Security Review Commission

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Challenges from Chinese Policy in 2022: Zero-COVID, Ukraine, and Pacific Diplomacy
Panel II: Russia's Invasion of Ukraine and Implications for Integrated Deterrence

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Hearing Co-Chairs Mann and Schriver, Commission members, and staff, thank you for the opportunity to speak with you today. I commend the Commission for calling a hearing on this critical subject.

Although we're just five months into the conflict, it's already clear that Russia's invasion of Ukraine marks a hinge in history — an event with far-reaching implications for geopolitics, the global economy, and the international order. It has shattered the theory that economic interdependence reduces the scope for conflict between great powers. It has proven that neither the involvement of nuclear superpowers nor the presence of McDonald's restaurants rules out large-scale military confrontations resembling the wars of conquest from centuries past. And it sounds the death-knell on the period of hyperglobalization that began in the 1990s and went into decline in the years following the 2008 global financial crisis.

This seismic event will have implications for countless areas of U.S. foreign policy. But perhaps most important of all are the implications for our policy toward China — in particular, our efforts to deter Chinese aggression in the Indo-Pacific. While we are still early in the Russo-Ukrainian War, it is not too early to begin drawing lessons from the conflict and applying them in a forward-looking way to U.S. policy toward China. As Russia's invasion of Ukraine demonstrates, revisionist powers can't be counted on to act in a predictable manner or on timelines projected by U.S. experts. So the sooner we can process lessons from Russia's invasion of Ukraine and translate them into tangible policy initiatives, the better.

My testimony today will focus on a specific set of lessons: those derived from the unprecedented economic sanctions that the United States and our allies have imposed on Russia in response to the invasion.

2014 vs. 2022

As the Russia and Europe Lead in the State Department's Office of Economic Sanctions Policy and Implementation — and later, as a member of the Policy Planning Staff — I was part of the team that designed, negotiated, and implemented international sanctions in response to Russia's

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2014 invasion of Ukraine and annexation of Crimea. The differences between our experience in 2014 and the more intensive sanctions campaign of 2022 are instructive, as they help reveal important lessons for the future of U.S. economic statecraft.

The biggest difference between those two episodes is that, in 2014, Russia's operation to seize Crimea took us by surprise. As a result, by the time Russia's little green men had secured control over Crimea, we had no sanctions options vetted and ready to go. There was no one at the State Department or the Treasury Department whose job was to develop sanctions against Russia; there was no international coalition in place to coordinate sanctions; and we had done no analysis to assess the targets in Russia's economy that were most vulnerable to sanctions — or the areas in our own economy that could face blowback in an economic conflict with Russia. Put simply, we were caught flat-footed. This explains why there was a four-month gap between President Barack Obama's signing of Executive Order 13662 on March 20, 2014 — which authorized sectoral sanctions against Russia — and the introduction of the first sectoral sanctions on July 16, 2014.

By contrast, in the current crisis, the first reports of Russia's military buildup on Ukraine's border came months before Vladimir Putin gave the fateful order to invade on February 24, 2022. The Biden administration, along with U.S. allies in the G7 and beyond, used the early warning to good effect, developing sanctions options, vetting them, and coordinating them in international contact groups. They also took the initiative to declassify intelligence on Russia's military buildup and Putin's intentions, depriving Moscow of the elements of surprise and confusion that it used to its advantage in 2014. This allowed the United States and our allies to attempt to use the threat of sanctions as a deterrent — an effort that ultimately failed — and to marshal significant public support for the imposition of sanctions after Putin launched the invasion.

Another key difference between 2014 and 2022 is that, in 2014, we had no experience wielding sanctions against large economies that were deeply integrated into the global financial system and supply chains. In 2014, Russia was the world's eighth-largest economy in nominal GDP and fifth-largest measured in terms of purchasing power parity. At the time, its economy was larger than the combined GDP of all other economies under U.S. sanctions. According to Nigel Gould-Davies of the International Institute for Strategic Studies, "Russia is the largest country ever to face major peacetime sanctions."[2] Developing sanctions against Russia was a wholly different enterprise from designing penalties on Cuba, North Korea, or even Iran. Major sanctions against Russia were likely to produce significant spillovers on the United States and our allies. They would not be cost-free. So, in 2014, it's not just that we were caught by surprise; we were embarking on an economic sanctions campaign with no obvious precedent.

By 2022, of course, the United States and our allies had eight years of experience with sanctions against Russia — and additional experience with export controls against an even larger economic rival: China. Consequently, in 2022, policymakers in the United States and allied countries were

[2] Nigel Gould-Davies, "Russia, the West, and Sanctions," *Survival: Global Politics and Strategy*, February–March 2020.

more confident in designing and implementing sanctions and other economic penalties. This was not their first rodeo, and it showed.

How to Design Strategies of Economic Statecraft

Economic statecraft is not a one-size-fits-all tool. Penalties against an individual Russian oligarch and restrictions on the Central Bank of Russia are both “sanctions,” but only insofar as a crossbow and an intercontinental ballistic missile are both “weapons,” or a schooner and an aircraft carrier are both “ships.”

Designing strategies of economic statecraft requires breaking the problem up into constituent variables and developing hypotheses about chains of causality. The first variable is the type of objective that the state is trying to advance with economic statecraft. I divide these into four categories of objectives: stigmatization, attrition, deterrence, and compellence.

Stigmatization involves punishing a foreign actor such that its behavior is stigmatized and, in turn, discouraging other actors from taking similar actions. Stigmatization is the easiest goal for economic statecraft to achieve, as it does not aim to change the target’s behavior. Instead, its intent is primarily symbolic — to “name and shame” and enforce a norm. Sanctions on individual human rights abusers, such as those enabled by the Global Magnitsky Act, are a typical case.

Second is attrition, which involves using economic damage to advance a discrete, material objective, such as degrading a state’s military capacity. Like stigmatization, attrition does not intend to change the target’s behavior, making it a relatively straightforward objective. The challenge for attrition is wielding economic statecraft tools in a manner that advances the attrition goal without leading to intolerable spillover effects. An example of this conundrum is evident in the 2014 U.S. and European sanctions against Russia. While Russia’s defense sector was an obvious target for economic statecraft, the West refrained from imposing full-blocking sanctions on Rostec, the main node of Russia’s military-industrial complex. That’s because Rostec has hundreds of subsidiaries, and broad-based financial sanctions could have therefore reverberated across the entire Russian economy. As a result, the West opted for more scalpel-like measures to attrit Russia’s military capacity.

Third is deterrence, which involves using the threat of economic harm to discourage a foreign actor from taking an action that it otherwise would take. Deterrence is a significantly more challenging objective than attrition, as it requires producing a shift in the target’s policy calculus. This is an area of economic statecraft that is underdeveloped and demands the most attention from Congress. The mechanisms by which economic statecraft can achieve deterrent effects are poorly understood. It is possible that the threat of additional economic harm drove Moscow to consent to the Minsk agreements in September 2014 and rein in Russia’s strategic objectives in Ukraine. This experience inspired additional attempts to use economic statecraft as a deterrent, including Congressional legislation aimed at deterring Russia from interfering in future U.S. elections.

Most notably, President Joe Biden attempted to use the threat of devastating economic consequences to deter Vladimir Putin from ordering a full-scale invasion of Ukraine in early 2022. This attempt at deterrence failed. But it was also relatively crudely designed. The exact consequences were never publicly spelled out, and the United States didn't take steps to ensure that Russia knew precisely what would happen in the realm of economic statecraft if it invaded Ukraine. In the future, the United States should explore additional measures to increase the likelihood of achieving deterrence, including enshrining specific triggers and economic consequences in mandatory statutes and international declarations. I'll provide more detail on these ideas later in my testimony.

Fourth is compellence, which involves using the prospect of either relief from economic harm or increasing economic harm to persuade a foreign actor to take an action that it otherwise would not take. Compellence is the hardest objective to achieve through economic statecraft. In recent years, the best example of successful compellence is the Joint Comprehensive Plan of Action (JCPOA), in which Iran agreed to constraints on its nuclear program in exchange for limited sanctions relief. Other attempts at compellence using negative incentives, including President Donald Trump's "maximum pressure" strategy against Iran, failed.

When devising an economic statecraft strategy, the first step is aligning on which of these categories of objectives the strategy aims to advance. This step is especially important, as certain tactical approaches may be better suited to one category versus another. The second step is determining a persuasive theory of success — in other words, a hypothesis for how economic harm will translate into the policy outcome that we seek. Will broad-based economic damage lead to popular discontent, which then puts pressure on an incumbent leader to change course? Will targeted economic harm incentivize elites to apply pressure to the incumbent leader? Perhaps a more precise form of economic damage could address the problem directly — for instance, blocking a state's nuclear development or plans for military modernization? Establishing hypotheses about chains of causality is critical to devise a successful policy. But this is seldom done explicitly by policymakers.

After developing a theory of success, the final step is choosing the best tools of economic statecraft to use. Policymakers have a wide range of tools at their disposal, including a diverse array of financial sanctions, trade sanctions, export controls, and investment restrictions. In parallel, it's important to model the potential for unintended spillover effects created by each tool. To illustrate, full-blocking sanctions tend to impose the swiftest and most severe economic harm on targets, but they also can be blunt instruments and carry high risks of unintended consequences — especially when applied to sizable targets.

Is China Vulnerable to Economic Statecraft?

By any measure, China is an economic behemoth. China possesses the world's second-largest economy. At more than $3 trillion, its foreign-exchange reserves are far and away the biggest in the world. [3] China is the leading trading economy and the top exporter of manufactured goods.

[3] Andrew Mullen, "China economy 2021: latest economic data about world's second-largest economy," *South China Morning Post*, April 7, 2021.

For U.S. economic statecraft, China presents a target of an entirely different magnitude from Russia. In 2021, China's economy was about 10 times larger than Russia's and its banks held more than 30 times more assets than Russian banks.[4]

But size does not equate to invulnerability. On the contrary, our experience with Russia hints that the more integrated a country is with the global economy, the more vulnerable it may be to economic statecraft. Our best evidence for this is the 2014 sanctions against Russia. Those sanctions were relatively modest. Instead of hitting Russia's largest banks and companies with full-blocking sanctions, we imposed restrictions limiting their ability to issue certain types of debt on U.S. and European capital markets.[5] At the time, such scalpel-like penalties were unprecedented — indeed, we designed them specifically to narrow Russia's economic horizons without pushing the country into a severe recession that could spread instability to the European Union and beyond.

For the sake of comparison, if the Iran sanctions in the leadup to the JCPOA were a 10 out of 10 in intensity, the Russia sanctions of 2014 were roughly a 2 out of 10.[6] Still, these sanctions sent Russia's economy into a tailspin, reducing Russia's economic growth by an estimated 2.5 to 3 percent (equal to about $50 billion) per year from 2014 through 2021.[7] This track record demonstrates that, for a country deeply reliant on U.S. and European financial markets and technology, even moderate sanctions can inflict substantial economic damage.

Today, China is even more enmeshed in the global economy than Russia was in 2014. This is especially true in the financial sector. China holds between 50 and 60 percent of its foreign-exchange reserves in dollar-denominated assets.[8] Because its holdings are so large, it has no viable alternatives to assets denominated in dollars, euros, pounds, or yen. This means that, in a conflict scenario, a significant portion of China's foreign-exchange reserves would be exposed to the risk of sanctions by the United States and our allies. Additionally, were China to try to dump its dollar-denominated holdings, it would be barred from doing so, as the assets would be frozen. Meanwhile, the geopolitical shockwaves of Chinese aggression — say, an invasion of Taiwan — would rattle world markets, leading to a flight to safety that would buoy U.S. assets.[9]

China's vulnerability to financial sanctions goes beyond its foreign-exchange reserves. China conducts just 20 percent of its trade in renminbi.[10] Much of the rest is settled in dollars. Consequently, broad-based financial sanctions on China would affect not just its trade with the United States, but with the whole world. A similar reality explains the precipitous decline in Russia's imports since it invaded Ukraine in February. As Matthew C. Klein has observed, the value of Russia's imports from the United States and our allies declined by 66 percent in April

[4] Gerard DiPippo, "Deterrence First: Applying Lessons from Sanctions on Russia to China," *CSIS Commentary*, May 3, 2022.
[5] Edward Fishman, "Make Russia Sanctions Effective Again," *War on the Rocks*, October 23, 2020.
[6] Tunku Varadarajan, "The West's Economic War Plan Against Russia," *The Wall Street Journal*, March 11, 2022.
[7] Anders Åslund and Maria Snegovaya, "The impact of Western sanctions on Russia and how they can be made even more effective," *Atlantic Council Report*, May 3, 2021.
[8] Rebecca M. Nelson and Karen M. Sutter, "De-Dollarization Efforts in China and Russia," *Congressional Research Service In Focus*, July 23, 2021.
[9] "Could the West punish China the way it has punished Russia?" *The Economist*, April 23, 2022.
[10] Nelson and Sutter, "De-Dollarization Efforts in China and Russia."

compared with the monthly average in the leadup to the invasion. Imports from neutral and pro-Russian countries, meanwhile, fell by 42 percent.[11] Why would imports to Russia from countries outside the sanctions coalition plunge by so much? Because the thicket of financial sanctions makes it difficult for Russia to pay for imports. Were China to come under sweeping financial sanctions, a comparable dynamic could well unfold.

China is also highly dependent on advanced technology from the West. In a conflict scenario, restricting China's access to such technology — as the United States and other democracies have done toward Russia in recent months — would cause China significant problems. Take airplanes. Commercial Aircraft Corporation of China (COMAC), a state-owned aerospace firm, has poured more than $70 billion into the C919, a competitor to the Boeing 737 and Airbus A320. Yet the essential parts of the aircraft come from the West — including the engine, which is produced by a joint venture between GE Aviation and France's Safran. (COMAC initially planned on using a homegrown engine, but it was forced to change course due to technical challenges.)[12] Russia's aviation sector is similarly dependent on the West. That's why, since the imposition of sweeping sanctions and export controls earlier this year, Russia has faced major difficulties maintaining its air fleet.[13]

In addition to aerospace technology, China relies on foreign suppliers for semiconductors. In 2021, just 20 percent of the semiconductors used in Chinese-made products were produced in China. Beijing has set an ambitious goal of increasing that figure to 70 percent by 2025, pouring tens of billions of dollars into the effort. But the chips made by Semiconductor Manufacturing International Corporation (SMIC), China's largest producer, remain several generations behind those made by the global leaders, Taiwan Semiconductor Manufacturing Company (TSMC) and South Korea's Samsung.[14]

A parallel dependency exists in software. After the Trump administration imposed export controls on Chinese telecom giant Huawei in 2019, a generation of the company's smartphones were deprived access not just to best-in-class chips, but also to Google's Android operating system. These restrictions led Huawei's revenue to decline by roughly 30 percent last year. Despite billions of dollars of investment into HarmonyOS, Huawei's alternative to Android, the vast majority of Chinese smartphones run on operating systems developed by Apple or Google, and virtually all Chinese desktops run on Microsoft Windows or Apple's macOS.[15]

All that said, just because China is vulnerable to Western sanctions — especially in the financial and technology sectors — it doesn't mean that economic statecraft against China would be easy. On the contrary, it would be exceedingly difficult. As potential targets of economic statecraft, China and Russia differ in a critical way that warrants emphasis. Even though Russia is a relatively large and integrated economy — especially compared with previous targets of sanctions — the West maintains escalation dominance over Russia in the economic sphere. For

[11] Matthew C. Klein, "Russia Sanctions Update," *The Overshoot*, June 29, 2022.
[12] "China wants to insulate itself against Western sanctions," *The Economist*, February 26, 2022.
[13] Mari Eccles, "Russia scrambles to save aviation as sanctions start to bite," *Politico*, May 6, 2022.
[14] "China wants to insulate itself against Western sanctions," *The Economist*.
[15] Ibid.

Russia, a tit-for-tat economic war with the West makes little sense, as Russia will always suffer far more than the West.

With China, the picture is quite different. While the West still outranks China in the global economy, there is much more parity between the West and China than there is between the West and Russia. China is also far more deeply integrated in global supply chains and markets than Russia is, so the unintended consequences of an economic conflict with China would be very difficult to contain. To illustrate, the United States may possess leverage over China in the semiconductor space, but, according to an analysis by the Boston Consulting Group, a complete ban on the export of high-tech components to China could cost U.S. chipmakers almost 40 percent of their revenues and endanger more than 120,000 American jobs.[16] Hard-hitting economic statecraft against China would be anything but cost-free. Crucially, moreover, the West doesn't possess the same unambiguous escalation dominance over China in the economic sphere that it wields over Russia. In other words, China could hit back — and partially insulated from popular discontent due to its closed political system, Beijing may assess that time would be on its side in a grinding economic contest with the West.

These caveats don't mean that the use of economic statecraft against China is a fool's errand. But they do indicate that the United States and our allies must be judicious in our application of these tools against the world's second-largest economy. Most important, we must institute rigorous processes to design, evaluate, coordinate, and implement sanctions, export controls, and other tools of economic statecraft against China. An ad hoc approach will not cut it.

<u>The Best and Worst Uses of Economic Statecraft Against China</u>

As outlined above, the first step in devising a strategy of economic statecraft is choosing the type of objective that we aim to advance. I have described four broad categories of objectives, ranked from least to most difficult: stigmatization, attrition, deterrence, and compellence. The former two objectives are material in nature; economic consequences are both the means and the end. The latter two are psychological; economic damage is a means to altering the behavior of the target government. That's why those two objectives, deterrence and compellence, are particularly hard to achieve.

When it comes to economic statecraft against China, the least promising objectives are those on the opposite ends of the difficulty spectrum. The United States has already deployed sanctions against China for the purpose of stigmatization — including individuals involved in undermining Hong Kong's autonomy[17] and government entities and officials that perpetrated human rights abuses against Uyghurs in Xinjiang.[18] These penalties are warranted, and they are worth building upon. They are not, however, intended to impose substantial economic pressure on China, nor can we reasonably expect them to alter Beijing's policies. In a scenario in which China commits

[16] Ibid.
[17] "Treasury Sanctions Individuals for Undermining Hong Kong's Autonomy," *U.S. Department of the Treasury Press Release*, August 7, 2020.
[18] "Treasury Sanctions Chinese Entity and Officials Pursuant to Global Magnitsky Human Rights Executive Order," *U.S. Department of the Treasury Press Release*, July 31, 2020.

military aggression against a neighbor, expanding these symbolic measures should be part of the U.S. response. But they should not be the centerpiece. If they are, they risk signaling to Beijing that the West is not serious about responding to Chinese aggression — perhaps because we lack the stomach for tough economic and military measures that carry significant risk. This, in turn, could inadvertently provoke China to broaden its territorial ambitions.

On the other side of the spectrum is compellence, which is the hardest objective for economic statecraft to achieve as it requires coaxing the target to retreat from an entrenched position. In a scenario in which China invades Taiwan, a compellence strategy would involve imposing substantial economic penalties on China and seeking to trade them for Beijing's commitment to pull back forces and restore Taiwan's autonomy. It is easy to see why such a strategy would be highly unlikely to succeed. Once Beijing decides to launch a military operation to assert control over Taiwan, it almost definitely will have done so with a high degree of preparation and commitment. While Chinese forces could pull back if they encounter stiff resistance, they cannot be expected to change course because of economic pressure alone. As a result, we should set aside compellence as a viable objective for economic statecraft toward China — for the same reasons that it is problematic as a goal of economic statecraft toward Russia.[19]

That leaves attrition and deterrence as the most promising objectives of economic statecraft toward China. Let's start with attrition. Since Putin ordered Russian forces to invade Ukraine, the primary goal of Western sanctions and export controls has been to degrade Russia's capacity to do more harm.[20] This is a reasonable goal for the measures, as Russia's defense-industrial base is dependent on the West for technology. Additionally, by sending Russia into a steep recession, sanctions will force the Kremlin to make hard tradeoffs between continuing to invest in military capabilities and maintaining living standards. But we cannot expect economic statecraft to achieve these goals rapidly; they will not affect Russia's ability to prosecute the war in Ukraine in the near-term, though they could affect the Kremlin's medium- and long-term military ambitions.

Degrading China's military capabilities would be even more difficult. That's because the Chinese government is far less resource-constrained than the Russian government. Moreover, Beijing has been more judicious in its use of military force in recent years than Moscow has been. If Beijing opts to invade Taiwan, it is highly unlikely that Western economic restrictions could meaningfully curtail Beijing's capacity to prosecute the war.

As a result, a better way to think about attrition in U.S. economic statecraft toward China is as a preventive measure — a strategy to deploy *before* China obtains certain capabilities that could damage U.S. interests, not afterward. Specifically, the United States and our allies should use tools of economic statecraft to prevent China from obtaining dominant positions in critical technologies, infrastructure, and other systems that it could exploit for its own coercive aims against the West. The campaign against Huawei and ZTE is emblematic of such a strategy. Were Chinese companies to gain dominance over global 5G networks, Beijing could eventually weaponize its central position in those systems for surveillance and coercion. That's why efforts by the United States and our allies to insulate our 5G networks from Chinese technology have

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[19] Edward Fishman and Chris Miller, "The New Russia Sanctions Playbook," *Foreign Affairs*, February 28, 2022.
[20] Ibid.

been so important. As Beijing seeks to obtain control over other critical economic chokepoints, the United States should seek to replicate this successful model of preventive attrition.

Deterrence also represents a promising and key objective of economic statecraft toward China. Our best chance at influencing Beijing's calculus is *before* it takes aggressive action against Taiwan or other neighbors. To be clear, economic statecraft can never replace military deterrence, which must be the linchpin of U.S. strategy to defend countries in the Indo-Pacific from Chinese aggression. But economic stagecraft can and should play a significant role in an integrated deterrence strategy.

At the beginning of this year, President Joe Biden threatened Russia with "swift and severe consequences" if Putin opted to invade Ukraine. Other leaders issued similar public threats, in what amounted to the most high-profile attempt in recent history to use economic statecraft to deter a military assault. That effort failed. But its failure does not indicate that deterrence is an unreasonable objective for economic statecraft. It's possible, for instance, that Putin underestimated the West's capability or will to impose devastating economic consequences on Russia. The fact that nearly two-thirds[21] of Russia's foreign exchange reserves were in euro-, dollar-, pound, or yen-denominated assets at the time of the invasion is strong evidence that Putin misjudged the West's readiness to hit the Central Bank of Russia with sanctions. Had Putin anticipated the West would go so far, he likely would have amassed Russia's war chest in assets less exposed to penalties by the G7.

For economic statecraft to play a meaningful role in deterring China from taking aggressive action against its neighbors, the United States and our allies must draw clear red lines, spell out the consequences of crossing them in advance, and demonstrate resolve to impose those consequences if China crosses the red lines. As I will detail later in my testimony, a combination of statutorily mandated triggers for sanctions and multilateral declarative policies will likely be necessary to satisfy these conditions. Signaling resolve to Beijing will be especially important. In addition to public declarations, putting skin in the game can advance this purpose. Just as forward-deployed U.S. forces in Europe and South Korea demonstrate U.S. resolve and contribute to military deterrence, stronger U.S. commercial ties with China's neighbors, including Taiwan, can fortify economic deterrence. If Beijing assesses that the United States has a lot to lose in material terms if it invades Taiwan, it may also assess that Washington would hit back forcefully in such a scenario; in turn, Beijing may think twice before invading in the first place.

China's Quest for Economic Security

In 2016, then Secretary of the Treasury Jack Lew gave a speech warning about the "risks of overuse" of sanctions. If the United States continued to use sanctions so frequently, Lew cautioned, "financial transactions may begin to move outside of the United States entirely —

[21] "Russia: Facing a severe economic and financial crisis," *Allianz*, April 2022.

which could threaten the central role of the U.S. financial system globally, not to mention the effectiveness of our sanctions in the future."[22]

Lew's speech correctly identified a trend in which other countries, including China and Russia, would seek to insulate themselves from the reach of U.S. sanctions. The implication of the speech that using sanctions more sparingly could reverse this trend is questionable. After all, once the power of U.S. sanctions was laid bare as Iran's financial system froze, its oil sales plummeted, and its economy spiraled in the leadup to the JCPOA, no government that may one day end up on the wrong side of such measures could afford to ignore them. But it is certainly true that as the United States and our allies have demonstrated this power time and again, including in the campaign against Huawei and in the recent sanctions against Russia, the incentive for revisionist powers to diversify away from the U.S. financial system has grown. The world is now engaged in a race for economic security, in which all major powers — including the United States — are striving to protect themselves from the economic weapons of rivals.

China's quest for economic security has taken several different forms. As discussed above, one of them is Beijing's push to attain independence in advanced technologies such as semiconductors. The most significant yet least developed of these initiatives, however, is Beijing's strategy to reduce its dependence on the U.S. dollar and Western financial infrastructure more broadly. This effort is especially important because, if it succeeds, it could insulate China and potentially other countries from the United States' most potent economic weapon: financial sanctions.

China has enshrined its objective to internationalize the renminbi and become a leader in global finance in its Financial Standardization Five-Year Plan (2021–2025), which was published this past February. Yet it is worth noting that China's growth as a financial power has lagged far beyond its rise as an economic power. While China is the world's leading trading country, accounting for 15 percent[23] of global exports, the renminbi's share of global currency in letters of credit and collections is less than 2 percent (the dollar, by contrast, represents a share of almost 90 percent).[24] China's efforts to elevate the renminbi as a global currency have been hamstrung by Beijing's reluctance to relax controls on the flow of capital in and out of the country. Despite Beijing's easing of some of these strictures, China's capital account remains one of the most tightly controlled in the world.[25] It is highly unlikely that the renminbi can become a major global currency unless Beijing fundamentally shifts its priorities and loosens these restrictions.

Nevertheless, China has begun developing financial infrastructure that could serve as the backbone of a more globalized renminbi, should that eventually come to pass. The centerpiece of this strategy is China's Cross-Border Interbank Payments System (CIPS), which the People's Bank of China (PBOC), the country's central bank, launched in 2015. While CIPS is sometimes

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[22] "U.S. Treasury Secretary Jacob J. Lew on the Evolution of Sanctions and Lessons for the Future," *Speech at the Carnegie Endowment for International Peace*, March 30, 2016.
[23] Alessandro Nicita and Carlos Razo, "China: The rise of a trade titan," *UNCTAD*, April 27, 2021.
[24] Emily Jin, "Why China's CIPS Matters (and Not for the Reasons You Think)," *Lawfare*, April 5, 2022.
[25] "Will China's Push to Internationalize the Renminbi Succeed?" *China Power*, April 1, 2020. Updated August 26, 2020.

viewed as an alternative to the Society for Worldwide Interbank Financial Telecommunications (SWIFT), which is based in Belgium, that's not quite right. SWIFT is a financial messaging service. It does not move funds between banks; rather it provides a standardized method for banks to send payments instructions to one another. Prior to SWIFT's founding in the 1970s, banks communicated with one another via telegraph and telex. These methods, of course, remain available, along with contemporary equivalents like email. Consequently, when a bank is barred from SWIFT, it does not lose access to the global financial system. It just becomes more burdensome to transact with that bank.

CIPS, on the other hand, is not a messaging service but an actual settlement mechanism. It is used to clear renminbi-denominated payments across borders. Its closest Western analogue is not SWIFT but the Clearinghouse Interbank Payments System (CHIPS), another institution founded in the 1970s and the main hub for clearing dollar-denominated transactions. So CIPS is not an alternative to SWIFT but rather a potential complement to it. In fact, it is estimated that 80 percent of all transactions through CIPS use SWIFT for messaging. This helps explain why, in recent years, SWIFT and China have deepened their relationship; SWIFT opened a unit in Beijing in 2019 and now supports messages in Chinese characters, making it compatible with China's domestic payments system.[26]

If China or any other country aimed to create an alternative to SWIFT, there would be no technological hurdle to doing so. The primary challenge would be getting banks to sign up and agree to use an alternative to SWIFT, which is a global standard. There are more than 11,000 financial institutions across over 200 countries that are connected to SWIFT, and the network processes more than 45 million messages each day.[27] For a utility like financial messaging, network effects apply — the network becomes more valuable as additional users participate in it. This creates a massive competitive moat for SWIFT. Moreover, if a competitor to SWIFT somehow was able to gain steam, the U.S. government could theoretically prohibit U.S. banks from participating in it, which would immediately undercut its utility. As a result, the potential rise of an alternative to SWIFT does not pose a major threat to the use of U.S. economic statecraft.

A more serious threat comes from the rise of the renminbi itself. Were China's currency to become as reliable of a medium exchange and store of value as the U.S. dollar is, it could serve as a real alternative to the dollar, thereby limiting the U.S. government's ability to wield financial statecraft. As discussed, this is still a distant prospect. But there are early signs that international usage of the renminbi is increasing in the wake of Russia's invasion of Ukraine. For instance, Chinese buyers of Russian oil have started paying for cargoes in renminbi.[28] While Russia has sought to de-dollarize its economy since it was first hit with financial sanctions in 2014, Moscow initially shifted to a preference for the euro.[29] Now it is driving toward a deeper financial alliance with China, expanding a currency swap line inaugurated in 2014 and

[26] Barry Eichengreen, "Sanctions, SWIFT, and China's Cross-Border Interbank Payments System," *CSIS Marshall Paper*, May 2022.
[27] www.swift.com
[28] Sharon Cho, "Chinese Buyers Given Flexibility to Pay in Yuan for Russian Oil," *Bloomberg*, April 1, 2022.
[29] Eichengreen, "Sanctions, SWIFT, and China's Cross-Border Interbank Payments System," *CSIS Marshall Paper*.

integrating Russia's Mir card network more closely with China UnionPay, an alternative to Visa and MasterCard.[30]

Another key part of China's financial innovation strategy is its central bank digital currency (CBDC), known as the digital renminbi or e-CNY. Because the e-CNY is a digital currency that is a direct liability of China's central bank, it can be transferred without using financial messaging services like SWIFT or clearinghouses like CHIPS or CIPS. It is effectively the digital equivalent of cash, with the critical difference that the PBOC retains visibility over e-CNY transactions.[31]

As with CIPS, however, the e-CNY will only threaten the use of U.S. economic statecraft if the renminbi itself can achieve parity with the dollar as a store of value and medium of exchange. Even in such a scenario, moreover, U.S. financial sanctions will continue to pack a punch so long as access to the dollar remains vital. For instance, if a foreign financial institution were to conduct a transaction in e-CNY that would otherwise violate U.S. sanctions, the U.S. government could target that institution with secondary sanctions — severing its access to the U.S. financial system. The only situation in which such a threat would become toothless is one where access to the dollar is no longer a necessity for banks, companies, and countries that want to participate in global commerce. Again, this is improbable anytime soon.

Where Do We Go from Here?

Russia's invasion of Ukraine — and the unprecedented sanctions that the G7 mustered in response — demonstrates the centrality of economic statecraft in U.S. foreign policy and contemporary geopolitical competition. The leading role of economic statecraft for the United States dates back more than a decade, when Washington ramped up sanctions against Iran in the years before the JCPOA. In that instance, it was not just the Obama administration but also Congress that drove U.S. strategy. For the United States to compete effectively in a world of intensifying geoeconomic competition, it is essential for both the Executive Branch and Congress to enhance the United States' capacity to design and execute economic statecraft.[32]

I encourage the Commission to consider the following policy recommendations:

- **Establish a permanent interagency committee in the Executive Branch for contingency planning and strategy development in economic statecraft.** The single most important lesson of the recent sanctions against Russia is that it is critical to plan in advance. The reason that the United States and our allies were able to impose unprecedented sanctions and export controls within days of Putin's decision to invade is that they had spent months developing a menu of options, vetting them, and coordinating them. This is a historical anomaly. The normal order of business is that the United States

[30] Jin, "Why China's CIPS Matters (and Not for the Reasons You Think)," *Lawfare*.
[31] Eichengreen, "Sanctions, SWIFT, and China's Cross-Border Interbank Payments System," *CSIS Marshall Paper*.
[32] For earlier articulations of some of these recommendations, see Edward Fishman, "Even Smarter Sanctions," *Foreign Affairs*, November/December 2017 and Edward Fishman, "How to Fix America's Failing Sanctions Policy," *Lawfare*, June 4, 2020.

only begins developing options for economic statecraft after a crisis has already started. As a result, we almost always run behind events. This procedure differs substantially from how the Department of Defense prepares for potential military operations, which involves rigorous planning, evaluation, and exercises. It is time for the United States to institute similar processes for the development of economic statecraft. Ideally, this could take the shape of a permanent interagency committee — say, an Economic Contingency Planning Committee (ECPC) — enshrined in statute like the Committee on Foreign Investment in the United States (CFIUS). The remit of the ECPC would involve developing options for the use of economic statecraft in different contingency scenarios, such as a Chinese invasion of Taiwan; modeling and evaluating potential economic and political consequences; and running tabletop exercises to identify weaknesses and account for them. While the ECPC can be staffed by personnel from various agencies, including the State Department and Treasury Department, it will require its own source of funding, as personnel involved in sanctions and export controls are already stretched thin.

- **Designate international contact groups for high-priority areas of economic statecraft and coordinate options developed in the ECPC in these fora.** Another major lesson of the recent sanctions against Russia is the importance of early and intensive coordination with allies. The degree of harmony between the United States and our allies on Russia sanctions is also a historical anomaly, rooted in the G7+ Russia Sanctions Contract group that we originally formed in 2014 in the wake of Russia's annexation of Crimea. With relations between the United States and China and Russia growing increasingly fraught, we can no longer rely on the UN Security Council as a primary body for coordinating sanctions. As a result, we need to form coalitions of the willing for high-priority areas of economic statecraft. For Russia, the G7 has emerged as such a coalition. It is essential that we also designate such a group for China-focused economic statecraft, as well as groups dedicated to other critical issues as they arise. In addition to planning, a major benefit of such groups is that they can issue joint declarations spelling out important policies and red lines. To that end, they could be used for deterrence. For instance, a China-focused group could issue a declaration detailing economic consequences for Chinese aggression against Taiwan or other neighbors.

- **For high-priority deterrence objectives, establish laws that identify triggers for significant economic penalties, establish a process for determining whether those triggers have been met, and prescribe a menu of options for penalties.** As discussed above, a tragic possibility about the Russian war against Ukraine is that Putin may have underestimated the West's readiness to impose devastating economic consequences, emboldening him to proceed with an invasion. In the future, Congress can reduce the likelihood of similar costly miscalculations by enshrining specific red lines in statutes and establishing a predictable process for imposing economic penalties on any country that crosses them. A model for such legislation is the Defending Elections from Threats by Establishing Redlines Act (DETER Act), which was introduced by Senator Chris Van Hollen (D-MD) and Senator Marco Rubio (R-FL) in 2018. While the DETER Act was aimed at foreign governments that interfered in future U.S. elections, the model could plausibly work for other scenarios, including a potential Chinese invasion of Taiwan.

Such an approach is viable because Congress possesses the power to wield economic statecraft. The benefit of enshrining such a strategy in law is that it will provide clarity to would-be aggressors about the consequences of their actions, which could strengthen the likelihood of deterrence working as intended.

- **Prepare contingency plans to defend against other countries' uses of economic statecraft.** In addition to planning for offensive economic statecraft, it is important for the United States to defend against the use of economic weapons by competitors such as China and Russia. The remit of the ECPC could expand to encompass such defensive contingency planning. For instance, the ECPC could identify potential shortages of critical natural resources or technological components in the event of a conflict with China and recommend proactive actions to mitigate them. Another aspect of such defensive planning could include highlighting potential chokepoints that other countries may seek to exploit and recommending actions for preventive attrition, as outlined earlier in my testimony.

- **Train and develop cadres of professionals skilled in economic statecraft.** While economic statecraft has come to play a central role in U.S. foreign policy, there are few, if any, government programs or funding streams dedicated to training personnel in economic statecraft. Designing and executing successful strategies of economic statecraft requires some degree of fluency in diplomacy, strategy, finance, technology, business, and regulation. Unfortunately, there are only a handful of graduate-level courses that teach this combination of skills. By contrast, nearly every graduate program in international relations includes modules on warfare and nuclear weapons. It's time for economic statecraft to assume a coequal place with these important subjects. In addition to expanding educational opportunities in economic statecraft, it would be valuable to establish exchange programs in which State Department officials can complete temporary tours of duty at the Treasury Department and vice versa. Just as years of war in Afghanistan and Iraq forged a generation of U.S. diplomats and military officers who understand each other's vocabulary, equities, and institutional touchstones, we need to train a new generation of diplomats and sanctions experts who are similarly well-versed in each other's domains.

For any of these policy initiatives to come to life, Congressional action will likely be necessary. Because of its mandate to make policy recommendations to Congress, the Commission can play an important role in strengthening U.S. economic statecraft.

It is an honor to address the Commission on this critical subject. Thank you for the opportunity.