

Should We Set the Market Free? Some Notes on International Economic Sanctions

On the last week of May 2003, in a 14-0 vote, with Syria absent, the U.N. panel agreed to lift economic sanctions on Iraq. In the last days, Iran claimed for a softening of US sanctions in order to enhance the cooperation on its nuclear projects. In the last years a big debate took place about sanctions, not only as regards Iraq, but also other famous cases as Cuba and Iran. But how much do we know about international sanctions? This article is intended to deal with some aspects of this issue.

First, sanctions appear to have been a common and recurring feature in political interactions between states. The United States, in particular, has been the major country imposing economic sanctions after World War II. No surprise at all, if we consider that the US applied economic sanctions even before becoming a state. In fact, in 1765 a boycott against British goods was imposed to protest the Parliament's ratification of the Stamp act. In 1919, Woodrow Wilson declared: "*A nation boycotted is a nation in sight of surrender. Apply this economic, peaceful, silent, deadly remedy and there will be no need for force*" (statement quoted by Hufbauer, 1999) Therefore, sanctions have been seen as a peaceful remedy to an ongoing conflict. In the last years, several sanctions imposed by a multilateral organisation like the United Nations have

been used, and some of them are still in force. In fact, since the Berlin Wall fell down, sanctions have become a common instrument of the United Nations Security Council.

WHAT ARE WE SPEAKING ABOUT?

Scholars usually distinguish between negative and positive sanctions. Negative sanctions are the best-known economic instruments of diplomacy. They are imposed in order to inflict an economic damage to one or more countries. Otherwise, positive sanctions are measures devoted to foster co-operation among some countries. For sake of simplicity, here I use the expression 'economic sanctions' to indicate roughly only negative sanctions. As it is common in the existing literature, by the expression 'sender' and 'target' I denote respectively the country that imposes sanctions and the country that receives the economic punishment. It is possible to look at economic sanctions with respect to: (i) objective; (ii) actors involved; (iii) object of sanctions.

As regards objectives of sanctions, following Barber (1979) it is possible to group them into three categories. There are 'primary objectives' concerned with the actions and behaviour of governments against whom the sanctions are directed. The 'secondary objectives' are related to status, behaviour and expectations of governments imposing sanctions. Finally the 'tertiary objectives' are concerned with broader international considerations, relating either to the structure of the international system as a whole, or to some parts of it. These three categories do not mutually exclusive, but can coexist and

overlap in some cases.

Another way to look at sanctions is to record the number of states involved. Most of the times the initiative in imposing international sanctions rests on one government. Indeed they can be both unilateral and multilateral. In the first case, sanctions are imposed by only one country against a target country. In the second case, sanctions are imposed by more than one country. On one hand, it is possible that other countries follow a 'promoter' country.

Sanctions are a common and recurring feature in international relations

Otherwise, the choice of an economic punishment can be adopted within the framework of an international organisation.

Looking at the object of sanctions, we can distinguish three main kinds of sanctions: boycotts, embargoes and financial sanctions. A boycott is a restriction of imports of one or more goods from the target country. It takes place to lower the demand for certain products from the target country. Moreover, it attempts to reduce the target's foreign exchange earnings and therefore its ability to purchase goods. It also aims at inducing a damage to a particular industry or sector of the target country. They are usually criticised as ineffective because target countries are able to find alternative markets or arrange triangular purchases to circumvent import controls. Otherwise, an embargo restricts exports of certain products to the target country. This is the most common technique. The prohibition on exports may be partial or complete. It is usually enforced by a system of export licenses and supporting measures. Finally, financial sanctions restrict or suspend lending and investing

into target economy. They also impose additional restrictions on international payments in order to prevent sanctions-busting. Moreover foreign assets of the target economy may be frozen.

EFFECTIVENESS AND COSTS

Negative sanctions are generally studied in relation to their effectiveness. Many scholars have devoted their efforts to distinguishing characteristics of degrees of success and failure of the economic punishment.¹ However, the efficacy of sanctions as an instrument of foreign policy is still in great doubt. Needless to say, no argument on effectiveness can be expounded without taking into account the costs. The common rationale behind the imposition of these measures is that the higher the costs for the target countries, the higher the probability that their government behaviour could be affected by welfare losses. Boycotts and embargoes, for instance, should deprive the target country of some of the gains of trade and therefore lead to a lower welfare. The costs for target countries are commonly assumed to be positively related with the degree of integration with the sender country. The more the economies are integrated, the more the economic interactions should be affected. On the other hand, the sender country could also be affected by imposing sanctions. In fact, commercial and financial linkages with target country agents are threatened, suspended or blocked.

¹ For examples of studies on the effectiveness of sanctions see among others Baldwin (1985), Hufbauer et al. (1990), Martin (1992), Van Bergeijk (1994,1995), Pape (1997), Bonetti (1998), Drezner (2000), Mastanduno (2001).

Therefore, the first impact we can evaluate is the impact on trade. Sanctions depress trade but, as other quantitative restrictions, they are characterised by a phenomenon of rent-seeking. Suppose now that a sender country imposes an export embargo on exports to the target country, restricting them. Since the embargo restricts supply, it also raises import prices in the importing country. A wedge between the international market price and the domestic price will reflect the quantitative restriction. A rent that can be distributed either to the government or to the private agents will appear. For simplicity of analysis we can stress that since an embargo is enforced through a system of licenses, it is operationally indistinguishable from a *Voluntary Export Restraint (VER)* and includes a rent that either pertains to the foreign exporters or is taken over by the government. In fact, the rent could be captured by the sender country's government if exporting licenses were competitively auctioned off for their premium value. Otherwise, the free issuing of licenses would transfer the rent to exporters who managed to obtain them. Exporters are likely to collude in order to capture the monopoly rents created by the imposition of the quota. At the same time an important implication is that the supply restriction requires state-sponsored collusive activity with cartel discipline maintained by the administrative powers of the government.

*The main
impact of
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Moreover, the shortfall in supply caused by the embargo could also benefit exporters not involved in the conflict between sender and target country. Third countries producers, in fact, could allow non-restraining

exporters to increase deliveries to the importing country expanding their market share. However, like in any other trade restriction, the greatest burden is imposed on the consumers of the importing country, i.e. the target country. In fact they must pay a higher domestic price for the good that results from its scarcity premium.

Another main feature is the focus on the behaviour of third countries. In case of multilateral sanctions, it is often argued that the economic punishment should be more effective, since more countries are involved in a co-operative and coercive behaviour. Whenever sanctions are unilaterally imposed, the impact could be questionable. On one hand, third countries agents, both public and private, may capture the gains of diverted trade. On the other hand, the expected negative effects of sanctions could spill-over to third countries.

An argument that is often remarked analysing the sanctions is the possibility that the sender country should face a phenomenon of trade diversion. It has been argued that *sanctions-busting* is always likely to occur. Sanctions are able to create powerful incentives for evasion. Trade can be diverted through new ingenious relationships devised by domestic and third-country firms. Particularly Drezner (2000) distinguishes if the sender country is unable to enforce the application of sanctions due to defections by private rent-seeking actors (*sanctions-busting*) or by nation-states (*backsliding*). This phenomenon is often indicated as one of the main reasons of failure of the economic punishment. Take Nicaragua in 80s under the Sandinista government. After the United States, under the Reagan administration, imposed sanctions on it, other western countries disagreed with American

policy. Canada, for instance, permitted Nicaragua to move its Miami-based foreign trade office to Toronto, stating that it had 'a perfect right' to sell Nicaragua anything it wants to buy. This is the rationale that very often led to diplomatic efforts for multilateral co-operation in sanctions enforcing. It is also behind the Helms-Burton Act and the Iran/Libya Sanctions Act, which threatens to punish third-country corporations that conduct business in Cuba, Iran, and Libya. Therefore, according to this point of view it could be argued that U.S. competitors trade with U.S.-targeted countries capturing the business when the United States imposes unilateral sanctions.

A different argument is expounded by Van Bergeijk (1995). He points out that, after sanctions have been imposed, changes in the world economic system occur. These changes also influence the economic opportunities of countries that are in no way involved in the conflict. These are the 'network effects' of sanctions. In many cases the impact of boycotts and embargoes does spill-over to trade partners (and to trade partners' trade partners and so on). Therefore, other countries will suffer from the trade disruption caused by sanctions. It would appear obvious that these arguments could be stressed if sanctions are unilaterally imposed. When sanctions are multilateral, what it would be expected is that the trade disruption phenomenon occurs at least for all countries involved in. In a recent research work (Caruso, 2003), I have analysed the effects of sanctions on G-7 countries other than the United States. Since these are supposed to have a similar exporting capability to the United States, the effects on bilateral trade flows of industrialised countries with target countries were assumed to proxy the impact of the U.S. sanctions on

third countries bilateral trade flows. The impact of U.S. sanctions on third countries is diversified. Limited and moderate sanctions show a slightly positive impact. Roughly, other G-7 countries increase their bilateral trade with U.S. sanctions-targeted countries. Thus, it seems that sanctions-busting works. On the other hand, comprehensive and extensive sanctions induce a disruption of trade for other countries too. In such a case, the network negative effects impact on other countries' trade. The estimated negative effect is very large. A negative effect is also obviously recorded when sanctions are multilateral.

Hufbauer et al. (2003) divided sanctions into three categories: limited, moderated and extensive. They considered minor financial, export, cultural, or travel sanctions to be "limited". Examples include suspending or reducing bilateral aid, and imposing export restrictions on weapons or narrow categories of dual-use technologies. Broader trade or financial sanctions were classified as "moderate". The "extensive" category is reserved for comprehensive trade and financial sanctions such as those against Iraq or Serbia.

*The debate
on the utility of
negative sanctions
is still open*

Sometimes, however, a combination of several "moderate" sanctions, such as U.S. export controls against the Soviet Union and Eastern Europe during the Cold War, together with denial of MFN status under the Jackson-Vanik amendment, were considered "extensive". As expected, extensive sanctions show a large depressing effect on bilateral trade flows. Otherwise the estimated impact for limited and moderate sanctions, however, is not

statistically significant. Moreover, they find little evidence to support the argument that sanctions continue to suppress trade after they have been lifted.

Another recent empirical analysis is the one presented by Askari et al. (2003). They measure the economic impact on the United States, some selected major target countries, and some third countries – the European Union and Japan. They also employ an augmented gravity model including dummy variables to investigate the impact of sanctions on trade. In this study, they intend to focus on the determinants of the U.S. trade flows (exports, imports, as well as total trade). Specifically, they use 19 years (1980-1998) of annual data for the U.S. exports, imports, and bilateral trade. Their findings show that the impact of U.S. economic sanctions on U.S. trade (bilateral trade, exports alone, or imports alone) is very sensitive to how the sanctioned country list is identified and selected. This is particularly true for countries specified as targets of U.S. selective economic sanctions.

For the three different classifications they have used, two of them show no consistent statistical significance. Using a sample that includes the formerly planned economies that have been for a long time the target of U.S. economic sanctions in recent history, they have found that sanctions have a significant impact on U.S. exports, imports, and total trade. Furthermore, comprehensive economic sanctions have a significant negative impact on U.S. bilateral trade, exports, and imports with target countries subject to these sanctions. They also investigated whether the *sanctions-busting* argument should be confirmed. They call it 'third country effect'. For the group of formerly planned economies, their trade (including bilateral trade, exports alone, and imports

alone) with the E.U. and Japan has been similarly affected by U.S. economic sanctions as their trade with the U.S. On the other hand, in the case of countries subject to comprehensive economic sanctions imposed by the U.S., there is no significant impact on these countries' trade with the E.U. or Japan. In some cases, they found that these sanctions have actually promoted trade between these countries and the E.U. or Japan. They interpret this as a clear indication of sanctions-busting or (as in their words) third-country effect.

CONCLUSION

This article simply underlined some aspects related to the costs of sanctions, in particular, with respect to the impact on international trade. Sanctions depress people welfare by depressing trade. In fact, when trade is blocked people suffer, simple to say, for lack of goods and services. Experience shows that sanctions affect the target country population more than the target regime. Take Iraq. The sanctions imposed in 1991 did not affect Saddam Hussein regime at all, but inflicted a heavy burden on people. Something similar happened in Cuba, Iran, and former Yugoslavia. This is also the rationale behind the debate, within the UN organisation, on 'smart sanctions'. Sender country firms also suffer from trade disruption. Moreover, analysing trade flows we can verify that without a strong international co-operation trade is diverted through third countries. People welfare is affected in such a case too. Rent gains flourish for a small

Sanctions have a small, but indispensable role in shaping international order

percentage of businessmen and government officials. In the gravest cases the impact of boycotts and embargoes does spill-over to the trade partners (and to the trade partners' trade partners and so on). These are the negative 'network effects' of sanctions. So, why sanctions? It should not be forgotten that sanctions are also an alternative to other instruments of conflict resolution. Would a war be less costly than sanctions? The answer appears to be negative. Signalling political hostility, avoiding the use of force, by means of sanctions is still the rationale behind the imposing of them.

But this was just a part of the story. What about the impact of positive sanctions? Should we set the market free? Should we allow the silent remedy of economic integration work? Could the liberal idea of peaceful spill-over of trade work? No doubt. This is a many millions dollars question. Classical Liberals believed that free trade meant more than just a more plentiful supply of goods and services. They also were confident that with freedom of trade a world of peace and international tranquillity would come. After World War II, economic integration in Europe allowed to build up a common basis to avoid bloody and never-ending struggles. The same happened with Japan. The system created after World War II had free trade as a founding pillar. In the aftermath of a war, the debate between negative and positive sanctions, between free trade and protectionism, should flourish. Sanctions are just a little part of this debate, but what happened and is happening in Iraq, Iran, Cuba (to quote the most famous scenarios) should foster a greater attention to the economic side of international order.

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