The Capital Market Sanctions Folly

A lesson in diplomatic dopiness.

BY BENN STEIL

The granting or withholding of trade "privileges" has taken on great metaphorical meaning since the end of the Cold War. America, the global power of international commerce and finance, bestows free trade agreements on nations that aid her in the war on terrorism. (Pakistan was so blessed by the Bush Administration in 2001, even though Congress declined to convert the metaphor into actual commerce.) America also punishes with economic sanctions those who oppose her. For those large enough to be particularly irksome in their opposition, such as China, the ultimate surrogate for traditional warfare has become capital markets sanctions. Here is the story of how capital markets assumed center stage in the emerging drama of economic statecraft.

CONGRESS TARGETS HOMELAND SECURITIES

In 1999, two congressionally mandated bodies (the Cox Commission and the Deutch Commission) released reports related to activities of the Chinese military and their links to Chinese commercial and financial activities either in the United States or involving U.S. firms. The conclusions of the reports were headline-grabbing in their focus on the purported role of the U.S. capital markets in providing finance, however indirectly, for Chinese weapons development and proliferation.

The report of the Deutch Commission concluded that:

> Because there is currently no national security-based review of entities seeking to gain access to our capital markets, investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators. Aside from the

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
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> moral implications, there are potential financial consequences of proliferation activity—such as the imposition of trade and financial sanctions—which could negatively impact investors.

This last sentence has proven a rallying cry not only for anti-China and national security hawks, but for activists of all stripes. A new logic had been proffered in a major congressionally mandated report which could be used to compel the U.S. government to harness the power of the capital markets, despised by groups on the right and left of the political spectrum, in the service of any manner of Great Cause. The logic was that since foreign companies doing wrong might be hit by American government punishment in consequence, American investors in such companies must receive government warnings of such companies' behavior, presumably in a manner such that they would be deterred from investing.

The Deutch Commission went well beyond calling for increased information flows, however. "…[I]t is essential," the report states, "that we begin to treat this 'economic warfare' with the same level of sophistication and planning we devote to military options." While noting that the Commission "was prohibited … from evaluating the adequacy or usefulness of sanctions laws," it nonetheless concluded that "the United States is not making optimal use of its economic leverage" and should "assess options for denying proliferators access to U.S. capital markets." This call has since escalated through several congressional bills.

"NOT ON MY MARKET!": THE CASE OF PETROCHINA

In September 1999, the first reports emerged that the China National Petroleum Company (CNPC) planned to list on the New York Stock Exchange. The proposed offering provoked strong objections from members of Congress, notably Representative Frank Wolf (R-VA), based largely on CNPC's business in Sudan. CNPC had invested about $1.5 billion in the Sudanese energy sector, and had reportedly committed multiples of that to future exploration and development in the country. Opponents of CNPC's New York listing claimed that it would assist the government in Khartoum in prolonging an eighteen-year-old civil war which they alleged had caused two million deaths and displaced twice as many.

CNPC, reacting to the political tempest in the United States, restructured itself such that only a subsidiary entity—PetroChina, from which Sudanese and other non-Chinese assets were excluded—would list on the NYSE. The move, referred to on Wall Street as a "Chinese Wall," infuriated CNPC's American detractors, who saw it as a meaningless bit of legal maneuvering to safeguard the U.S. listing while allowing the Sudanese operations to develop unhindered.

The public campaign against PetroChina's U.S. initial public offering was waged by members of Congress at the conservative and liberal ends of the spectrum, former Republican government officials, organizations associated with the Christian Right, the AFL-CIO, a protectionist small-business lobby group called the U.S. Business and Industrial Council, and the William J. Casey Institute, named for the late CIA director. Whereas most of PetroChina's detractors expressed concern for human and religious rights in Sudan, they were united only in their loathing of China.

The ultimate surrogate for traditional warfare has become capital markets sanctions.

The Casey Institute, chaired by Roger W. Robinson, Jr., was commissioned by a third Congressionally mandated body, the U.S.-China Economic and Security Review Commission, of which Robinson was a member, to prepare a report on the use of capital markets sanctions against China. The report's fantastical accounts of the "successful" capital markets sanctions campaigns against PetroChina and the Russian oil giant Gazprom would make an account of the CIA's "successful" venture in the Bay of Pigs seem almost plausible.

The epilogue, however, turns out to be far more telling than the tale.

Over the past four years, CNPC has become the major force in the Sudanese oil industry, having been wholly undeterred by the efforts to bar it from the U.S. capital markets. By 2002, China was Sudan's most important customer. About 75 percent of Sudan's exports are petroleum products, and 85 percent of such products go to China via CNPC. By 2003, CNPC's production base in Sudan accounted for nearly half the company's overseas oil production, making Sudan China's fourth largest oil supplier.

By January 2004, PetroChina's share price had quadrupled—powerful testimony to the utter irrelevance of the capital markets sanctions campaign either to the company's business strategy or its performance. In the end, the Coalition's "tireless efforts" changed nothing in China, and nothing in Sudan. But the good news is that PetroChina's American investors never actually suffered from the "political risk" the Caseyites claimed to be so eager to protect them from.

The notion that CNPC would have sacrificed its huge Sudan business for an NYSE listing is ludicrous. As of August 2003, the value of U.S. institutional holdings in PetroChina stock was twice as large in Hong Kong as it was in New York.

On April 2, 2001, Representative **Frank Wolf** *(R-VA) [right] wrote a letter to SEC Acting Chairman* **Laura Unger** *excoriating PetroChina and NYSE-listed Canadian energy company Talisman for "offenses" in relation to their activities in Sudan. "… [T]he SEC," he asserted, "with its authority and mandate to oversee disclosure to inform and protect investors, should recognize material omissions by the companies as a violation of their disclosure requirements and take appropriate action."*
—B. Steil

In other words, not only was PetroChina capable of attracting U.S. capital through the Hong Kong Stock Exchange, but it actually proved more successful in attracting it through Hong Kong than New York. Warren Buffett, not normally considered to be a naïve investor, controlled nearly 14 percent of PetroChina shares at the beginning of 2004, and 95 percent of his stake is held through purchases on the Hong Kong Stock Exchange.

The best way to understand the significance of this finding is that the savings to CNPC's cost of capital owing to its NYSE listing amounts to mere pocket change, particularly when viewed side-by-side with the cash flow deriving from its Sudan business. Now, actually to imagine that the United States could persuade the regime in Khartoum to cease actions it considers vital to holding power by barring a Chinese oil firm from listing on the NYSE is to elevate imagination well beyond any legitimate role it should play in foreign policy formulation.

The image of religious freedom watchdogs, China hawks, Tibetan independence advocates, unionists, and environmentalists all joining hands—"the Sudan Community," as the Caseyites call the motley kumbaya collection—to oppose foreign investment in Sudan is both misleading and disingenuous. Prominent human rights advocates actually living in Sudan had been extremely critical of a June 2001 House bill (an embryonic version of the 2002 Sudan Peace Act) aimed at punishing foreign oil companies doing business in the country. "This isolation by the international community for nine years did not work," according to Rifaat Makkawi, a Khartoum-based human rights lawyer.

Has the government in Khartoum repented for the sins which led to passage of the 2001 House bill? Hardly. In 2004 the regime was the target of widespread charges of complicity in ethnic cleansing and genocide in the western region of Darfur, where an estimated 50,000 people died and 1.2 million fled their homes. Preventing such a humanitarian disaster would have required dedicated and muscular diplomacy. America chose instead to bludgeon foreign companies with sanctions threats, as foreign companies are an easy political target with no domestic constituency.

The notion that American capital is "domiciled in New York City" is dangerously naïve.

HIJACKING THE SEC

> [The U.S. Markets Security Act] calls for a national security office within the SEC … It is responsive both to current trends and forward looking to the age when economic warfare may supersede more traditional forms of warfare.
> —REP. GERALD SOLOMON (R-NY)

On April 2, 2001, Congressman Frank Wolf wrote a letter to SEC Acting Chairman Laura Unger excoriating PetroChina and NYSE-listed Canadian energy company Talisman for "offenses" in relation to their activities in Sudan. "… [T]he SEC," he asserted, "with its authority and mandate to oversee disclosure to inform and protect investors, should recognize material omissions by the companies as a violation of their disclosure requirements and take appropriate action." He then laid out a laundry list of investment "risks" which PetroChina failed to reveal in its filings. Among these omissions, "The prospectus contained no accounting of the massive public opposition campaign levied against PetroChina," of which Wolf was a part, "and the potential risk to investors of this ongoing activism on share value"—a risk not immediately apparent in the stock's 17 percent rise over the year between its NYSE launch and the date of Congressman Wolf's letter, or the 300 percent rise by the beginning of 2004.

Despite making clear to the congressman that foreign companies doing business in countries subject to U.S. sanctions, such as Sudan, were neither subject to those sanctions nor in any way barred from offering their stock in the United States, *U.S. investors go abroad to invest in foreign companies. They do not sit in "New York City" waiting for the world to come to them.*

Unger concluded that "The SEC does, however, have statutory authority to require that U.S. investors receive adequate disclosure about where the proceeds of their securities investments are going and how they are being used." This conclusion was reached regardless of whether such disclosure was merited by her own staff's assessment of materiality. She further revealed that she and members of her staff had met with the director and staff of the U.S. State Department's Office of International Religious Freedom, with whom she had personally raised "the possibility of interagency cooperation on Sudan." Somehow one doubts that they also discussed the plight of Scientologists in Germany, or how the SEC might alleviate it by investigating German companies listed in New York.

Indeed, in rendering a "material risk" any activity of a foreign company which the SEC could be successfully pressured to so label, there was literally no limit to the scope of foreign policy opinions (and opinions they are, as no legislation or Executive Order is necessary) which pressure groups could champion through the SEC's disclosure, investigation, enforcement—and, now, "interagency cooperation"—regimes.

In July 2001, the large Russian oil company Lukoil reacted to the Unger letter by withdrawing its planned share listing on the NYSE, choosing to move it instead to the London Stock Exchange, citing the "political risk" now associated with an American listing. The relentless badgering of the SEC to politicize its disclosure requirements, under the guise of informing investors of "political risk" in foreign investments, had succeeded in creating political risk in American listings, driving capital-seeking companies outside the SEC's jurisdiction entirely, where they continue to access U.S. as well as foreign capital via cross-border electronic trading links.

Lukoil's decision was nonetheless celebrated by former Assistant Secretary of Defense Frank Gaffney, who now heads the organization controlling the Casey Institute, in a July 2001 *Washington Times* op-ed, as a "development of momentous significance." Of far greater significance is the dangerous level of ignorance within parts of the U.S. defense and intelligence establishment as to the workings of the capital markets, given that some of their notables have been turning to the most foolish possible forms of market regulation as a substitute for real foreign policy.

WHERE IS "AMERICAN CAPITAL"?

> With the largest share of the world's available development capital domiciled in New York City, we have in our possession the kind of leverage that, if used prudently and constructively, can make the United States and our allies more secure in the 21st century, even if employed unilaterally.
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> —CASEY INSTITUTE CHAIRMAN ROGER W. ROBINSON, JR.

The notion that American capital is "domiciled in New York City" is dangerously naïve. American capital may be owned by Americans, but it is effectively undomiciled. For 122 EU-based firms listing ADRs (American depository receipts) in the United States (on the NYSE and Nasdaq) in 2003, U.S. institutional investors held, on average for each company, 7.7 times as much of the underlying stock listed in Europe as they did of the ADRs. For mainland Chinese firms, the ratio of U.S. institutional holdings in Hong Kong to holdings on the NYSE is 5.8.

The clear message from these data is that U.S. investors go abroad to invest in foreign companies. They do not sit in "New York City" waiting for the world to come to them (subject to Mr. Robinson's permission). Critically, American capital market sanctions can only accelerate this trend of driving investors and listings abroad.

THEN WHY CAPITAL MARKETS SANCTIONS?

Supporters of capital markets sanctions see them as much more than a tactic in a battle to achieve certain foreign policy ends. Whether on the right or the left, they tend to see capital market institutions such as the New York Stock Exchange as the centerpiece of an amoral, international, "neo-liberal regime" that undermines national interests and "traditional" social orders. They mirror the right and left wings of the anti-globalization movement, which accord almost mythic political powers to the three Bretton Woods institutions—the IMF, the World Bank, and the WTO. This accounts for much of the naïve triumphalism which surrounds the epic sanction tales of PetroChina and Gazprom—rank failures in terms of achieving foreign policy aims, but deemed heroic for the fight itself. Unfortunately, it seems that capital markets sanctions are an idea whose time has come, and will most likely keep on coming, despite their having earned pride of place in the pantheon of diplomatic dopiness. ◆