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# MEETING THE CHALLENGE OF SECONDARY SANCTIONS

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## SUMMARY

- Secondary sanctions have become a critical challenge for Europe, due to the Trump administration's maximalist policy on Iran and its aggressive economic statecraft.
- Europe's vulnerabilities mostly result from asymmetric interdependence with the US economy, due to the size of US markets and the global role of the US dollar.
- In future, states will likely weaponise economic interdependence with the EU to target countries that are more important to the European economy than Iran, such as China and Russia.
- European countries should demonstrate that, despite their economic interdependence with the US, they control EU foreign policy.
- The EU should begin to build up its deterrence and resilience against secondary sanctions, and prepare to adopt asymmetric countermeasures against any country that harms European interests through secondary sanctions.
- They should also attempt to bolster the global role of the euro and lead a robust international dialogue on the role of sanctions.

Europe's exposure to US secondary sanctions is a major foreign policy challenge for which there is no easy solution. The Trump administration's withdrawal from the Joint Comprehensive Plan of Action (JCPOA) and imposition of such sanctions have harmed European countries' interests in nuclear non-proliferation and laid bare their limited ability to implement an independent strategy on Iran. Although Europe and the United States continue to closely coordinate their sanctions policies in other situations, disagreements between them – such as on the JCPOA – have led to not only a sharp divergence in their approaches to sanctions but also a clash between their respective foreign policies.

Indeed, last summer, European capitals were reminded of the harsh reality that, through secondary sanctions, Washington can use access to the US markets as a source of immense political power. As the US is one of Europe's largest trade and financial partners, it is hard to find any European business that does not have direct or indirect exposure to these markets and systems. Given its extensive power to investigate and fine European actors – and to cut them off from the US market – the US Treasury's influence prevails when US and EU regulations and foreign policy diverge. As such, the mere threat of US secondary sanctions on European entities has led to an exodus of EU companies from Iran and undercut a nuclear deal that once stood as a signal achievement of European foreign policy.

While past US governments have also adopted secondary sanctions, the administration led by President Donald Trump has used such measures in ways that create unprecedented problems for Europe. Many European officials worry that secondary sanctions are increasingly

addictive for both the White House and the US Congress. Under the Obama administration, the US tried to gain international support for its extensive sanctions on Iran through the European Union and the United Nations. But, under Trump, secondary sanctions are proving to be a hugely powerful measure, at least in the short term – meaning that all bets are off as to how his administration will use them in future.

The Obama administration's secondary sanctions against Iran were part of a foreign policy more or less coordinated with that of the EU. Under Trump, European governments have, for the first time, begun to think seriously about how to escape or even counter the measures. Their efforts have the support of the many European companies and political figures who see a robust response to US secondary sanctions as indispensable insurance – both economic and political – against possible US interference in Europe's relationships with other countries, including Russia and China.

Despite their scramble for countermeasures that can minimise the impact of these sanctions on their commercial and – more importantly – strategic interests, the EU and its member states have been unable to significantly shift Washington's stance. They have also failed to dissuade European companies from pre-emptive alignment and overcompliance with US secondary sanctions.

More than the nuclear deal is at stake: regardless of whether the agreement survives in the coming months, it is clear that European governments need a better response to secondary sanctions. European countries need to reassure companies that they can conduct business within the contours of EU law and policy. And they must demonstrate to the world that, despite their interdependence with the US, European capitals ultimately control EU foreign policy. The Iran case has fully exposed European capitals' weakness in this area, reducing their bargaining power vis-à-vis both Tehran and Washington.

Europe's vulnerabilities to US secondary sanctions result mostly from its economic interdependence with the US. Political scientists Henry Farrell and Abraham Newman challenge the argument that globalisation results in reciprocal dependence, which tends to make coercive strategies less effective. On the contrary, as they note, asymmetric network structures, such as global financial platforms that flow through the US, "create a condition of 'weaponized interdependence' in which some states are able to leverage interdependent relations to coerce others". Due to its dominant position in global economic networks, the US has not experienced asymmetric dependence on trade with Europe as an obstacle to imposing its coercive strategy.

Europe could respond by reducing such interdependence – but this would not be in its broader interests, either economically or politically. A more viable option is to minimise Washington's opportunities to use US-EU interdependence in ways that restrict European freedom of action. This can be done by both reducing the asymmetry

in such interdependence and by showing a determination to leverage other aspects of interdependence for Europe's benefit where necessary.

This paper assesses Europe's main vulnerabilities to secondary sanctions and proposes policies that will restore its freedom of action – or, at least, minimise these measures' impact. It argues that, beyond the immediate issue of Iran, there is a need for European capitals to create longer-term plans for responding to any third country's enforcement of secondary sanctions against the EU. The US stance on sanctions could grow ever more aggressive – even under a new administration. Other countries, such as China, could start to use similar measures to increase their geopolitical influence. European actors must build up their resilience against secondary sanctions and create a process for responding to such measures in ways that better serve their interests.

## The weaponisation of US sanctions

In recent years, the US executive and legislative branches have increasingly resorted to sanctions in ways that limit choices for European governments and companies. Given that there is bipartisan support in the US for expanding the use of secondary sanctions, future presidential elections are unlikely to substantially reverse this trend.<sup>1</sup> A growing number of voices in Europe's commercial and policy spheres caution that the US is likely to often use secondary sanctions in ways that have "damaging consequences" for European commercial and security interests.

The current situation has precedent. A major showdown between the US and Europe over sanctions policy came under President Ronald Reagan's administration, which targeted Moscow's plans to build a gas pipeline running from Siberia to Europe by imposing a ban on related equipment sales to the Soviet Union. Then as now, European countries decried Washington's use of extraterritorial sanctions. Even UK Prime Minister Margaret Thatcher was outspoken on the issue and, despite her close relationship with the US president, joined a European effort to push back against this policy. However, unlike today, European company executives openly said that, if their government ordered them to disregard US sanctions, they would do so. Following political uproar in Europe, the US eventually lifted the sanctions.

In the mid-1990s, the US Congress imposed extraterritorial sanctions on Cuba, Libya, and Iran that angered many European leaders. This time, European governments lodged a complaint at the World Trade Organisation (WTO); adopted a new Blocking Regulation that prohibited EU entities from complying with the US sanctions; and engaged in extensive political negotiations with the Clinton administration. Together, these responses persuaded the US not to impose the sanctions on European entities – although the Trump administration recently rescinded these waivers.

The expanded global reach of US sanctions and the enhanced influence of the US Treasury on European companies came to light under the Obama administration. By then, US and

<sup>1</sup> Comments from a former senior US Treasury official, February 2019.

## Primary and secondary sanctions

**Primary sanctions** prohibit companies and individuals in the sanctioning country from engaging with their counterparts in the sanctioned country. Such sanctions apply to US persons, as well as US-origin goods and transactions that take place on US territory or in which the US can assert its jurisdiction.

**Secondary sanctions** are as Jack Lew, then US Treasury secretary, said in 2016: “generally [directed] towards foreign persons. These measures threaten to cut off foreign individuals or companies from the U.S. financial system if they engage in certain conduct with a sanctioned entity, even if none of that activity touches the United States directly.”

European economies and financial institutions had become so integrated with one another that, by leveraging the dominance of the US dollar, Washington turned secondary sanctions into one of its most powerful and effective trade restrictions to date.

The Obama administration took unprecedented steps towards strengthening its secondary sanctions through its oversight of, and expansive reach into, global financial institutions. According to one senior banking executive based in Europe: “when the US began using its secondary sanctions, it didn’t know if it would work. There was trial and error involved. If, at that time, all of the European central banks resisted these measures, it is uncertain if the US could target them” – either politically or by including them on its specially designated nationals and blocked persons (SDN) list.<sup>2</sup>

While the US perfected its ability to impose secondary sanctions on companies, European countries fell in line with US foreign policy on Iran. During 2010-2012, the EU and the US introduced their most crippling sanctions on Iran’s energy sector to date. They did not clash over the issue because their sanctions policies were broadly similar. For example, in 2012, Congress introduced legislation to disconnect Iranian banks from the Belgium-based SWIFT – the key financial messaging company for global payments. Seeking to present a united front with the US, the EU passed a similar regulation shortly thereafter.

By choosing not to push back against US sanctions on SWIFT in this instance, Europeans joined decisive efforts to coerce Iran. But they also set a dangerous precedent that the United States’ lawmakers and executive branch have followed in targeting Iranian banks – and could follow in targeting Venezuela or even Russia. As several European but also US policymakers involved in the decision on SWIFT in the Obama era now admit, they would have been more cautious had they believed that Trump would become president.<sup>3</sup>

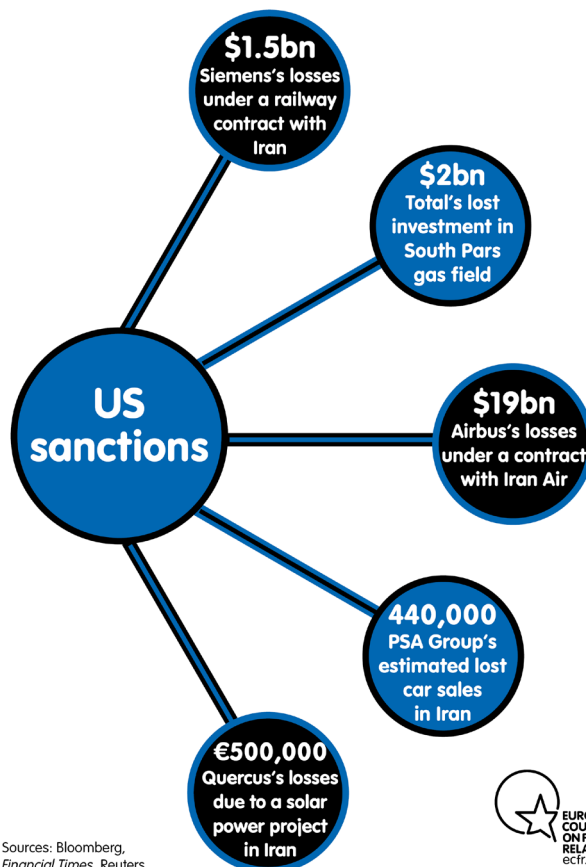
<sup>2</sup> ECFR interview, December 2018.

<sup>3</sup> Interview with an EU diplomat, December 2018, and comments from a former senior US Treasury official, February 2019.

Part of the effectiveness of US secondary sanctions stems from the power of the Office of Foreign Asset Control (OFAC), which can dedicate unparalleled resources to sanctions designations, implementation, and enforcement. According to one former senior US Treasury official, US district and appeals court rulings imply that the executive branch has significant discretion in this area.<sup>4</sup> While no case has been brought before the US Supreme Court, several legal experts believe it is highly likely to favour executive discretion on sanctions policy.<sup>5</sup>

The uncertainty surrounding the operation of secondary sanctions has also enhanced their impact. A lack of clarity on how to interpret the measures and how they will be enforced has led to a high degree of overcompliance by European companies and banks, which prefer to cut ties to Iran rather than risk inadvertently falling foul of the sanctions framework. OFAC has responded slowly or inadequately to European governments’ repeated efforts to gain clarity on these issues; most commentators see this pattern of behaviour as deliberate, since it increases the impact of US measures. As demonstrated by the Trump administration’s approach to waivers for continued purchase of Iranian oil, the limited and temporary exemptions the US may issue to European companies only add to the measures’ aura of unpredictability.

## Estimated cost of US sanctions for European companies: select losses



Sources: Bloomberg, Financial Times, Reuters



<sup>4</sup> Comments from a former senior US Treasury official, February 2019.

<sup>5</sup> ECFR interview with legal experts, April 2019.

## *The likely development of secondary sanctions*

US officials have suggested that they could enforce the secondary sanctions the Trump administration imposed on Iran in November 2018 in a draconian manner, with National Security Advisor John Bolton noting that “it’s possible” the US will target European companies with the measures. These firms take such threats extremely seriously. The US has, in some rare instances, added European entities to its SDN list, leading to their assets being frozen and effectively disconnecting them from global financial markets.<sup>6</sup> Such designations could have a tenuous justification that goes beyond the reasonable due diligence expected of a company. For example, the Trump administration surprised many in Europe by adding Parsian Bank, a well-known Iranian private company, to its SDN list for allegedly having links with the Islamic Revolutionary Guard Corps. This forced European banks to sever their ties to the institution.

In future, the US could, in theory, add any European entity, including central banks and SWIFT, to its SDN list. (Listing SWIFT would be a bizarre move, given that it would harm US banks by preventing them from using the organisation’s unparalleled financial messaging services.)

The US could also impose travel bans or asset freezes on Europeans who facilitate forms of trade subject to US secondary sanctions. Given the effectiveness of US secondary sanctions as a tool of foreign policy, it is likely that both Democrat and Republican leaders will continue to adopt them.<sup>7</sup> OFAC is also likely to maintain its deliberate ambiguities as well as its heavy-handed approach to enforcement, or at least threaten to do so in ways that cause European companies to pre-emptively fall in line with the US sanctions framework. Moreover, the current US government is almost certain to remain indifferent to the kind of international support for sanctions the Obama administration sought as its preferred option.

So far, US sanctions on Iran have had limited economic consequences for Europe. But if Washington were to impose secondary sanctions on a far more important European trade partner, such as Russia or China, the hit to Europe would be far harder.

## **The stakes for Europe**

### *Europe’s vulnerability to secondary sanctions*

Washington maintains that its secondary sanctions are not extraterritorial but rather present foreign companies with a choice between access to markets in the US or in the targeted country.

The importance of the US market, in both absolute and relative terms, is enough to change the business decisions of most major European companies. But even small and medium-sized enterprises (SMEs) that may have no direct exposure to the US market still need to use banks that want to retain access to the US dollar, US financial markets, and

their US clients. As a consequence, Europe is also vulnerable due to the integration of its financial markets with the much larger US one – and not just through its extensive trade, investment, and technological relationship with the US.

Other aspects of the financial system – such as the role in transactions of Visa, Mastercard, and other US companies (which can be leveraged in sanctions on individuals), or the impact of US sanctions policy on SWIFT – only exacerbate this vulnerability.

The relatively passive European response to US secondary sanctions has also increased this vulnerability. According to one former US Treasury official, the Trump administration and some members of Congress see Europeans as posing far less of a challenge to the enforcement of the measures than, for instance, the Chinese. In response to US sanctions on Iran under Obama, China set up a financial payments system that ran parallel to dollar-denominated channels, drawing the interest of countries that would like to set up their own systems of this kind, such as Russia. In comparison, Europe’s most forceful response has been to establish the Instrument for Supporting Trade Exchanges (INSTEX), which is currently confined to facilitating the kind of humanitarian trade with Iran that is permissible under US sanctions.

However, Europe is not alone in feeling the pressure of US secondary sanctions. For decades, China, India, Russia, and Turkey have attempted to bypass the impact of such US unilateral measures. Yet, in response to the latest wave of US secondary sanctions on Iran, each of these countries has felt more exposed to US sanctions – even though they (especially Russia and China) have less exposure to the US than Europe. The impact of this has been seen in the notable drop in trade between Iran and China in the initial months after the US reimposed sanctions in November. China, India, and Turkey have also seemingly linked negotiations with the US over exemptions to these sanctions to an array of political factors, such as China-US trade talks. China is looking closely at European plans for establishing a special purpose vehicle (SPV) and European officials privately note that China has expressed interest in collaborating on such a mechanism to trade with Iran.<sup>8</sup>

In large part, the US does not take Europe seriously due to the continent’s political fragmentation. Many European countries – particularly, but not exclusively, those in the east – are careful to avoid a confrontation with the US over secondary sanctions out of fear of undermining transatlantic relations. This phenomenon would likely play an even bigger role in other cases, such as sanctions targeting Russia, on which European divisions run deeper.

These intra-European differences are also evident on the tactical level: some European countries having sought preferential arrangements with the US through exemption requests. This approach not only provided minimal, piecemeal US waivers on oil imports in November 2018 but

<sup>6</sup> ECFR interviews with European officials, January 2019.

<sup>7</sup> Comment from a former senior US official, February 2019.

<sup>8</sup> ECFR interviews with European officials, January 2019.



also ran against other EU members' call for collective rather than bilateral negotiation of exemptions. In any case, such waivers are intended to be limited in scope and duration to prevent Europe and Iran from establishing longer-term business ties. Indeed, the US announced in April that it would not prolong its waivers to Italy and Greece (as well as a handful of non-EU countries) to continue purchases of Iranian oil.

Unity will be key, especially at a time when the US is explicitly playing on European divisions and multiplying transatlantic disputes – on trade and other issues. Internal divisions will weaken Europe's hand in talks with the US and in establishing a more formal response to secondary sanctions.

### *The risk for Europe: A test for European foreign policy autonomy and credibility*

Given all these vulnerabilities, the EU has struggled to determine its economic and strategic relationship with Iran. What is at stake here is not Europe's relationship with the US – at least, no more than in any case in which the EU protects its trade interests or imposes its competition policy decisions on US companies. Rather, this is about Europe's ability to freely determine its foreign policy without being coerced, or seeing its economic actors being coerced, into following another power's policy.

In responding to secondary sanctions, the union needs to understand how it can use interdependence to rebalance the relationship without undermining transatlantic relations, and to share risks between member states in a fashion that promotes European unity. Should it fail to uphold one of its major foreign policy achievements, the JCPOA case would set a terrible precedent for the EU's ambition to be an autonomous and credible actor.

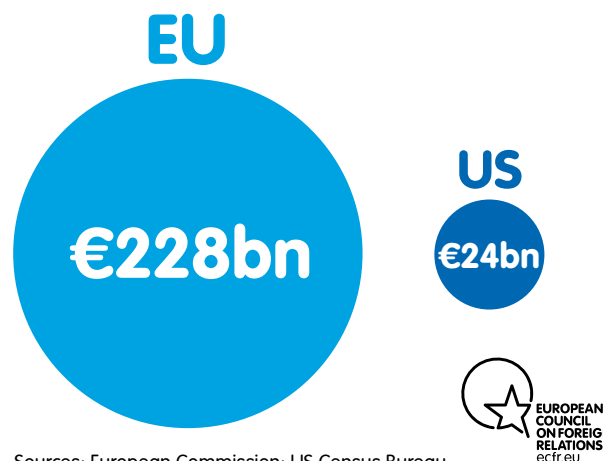
Arguably, the transatlantic dispute over Iran has already diminished Europe's diplomatic influence: third countries are now liable to ask why they should negotiate with European capitals if Washington, through its secondary sanctions, has the final say on European policy. Accordingly, the EU's sanctions will lose some of their value as an autonomous foreign policy tool – if it cannot effectively lift them when its goals and conditions are met – even as it increasingly adopts such measures.

A broader risk lies in the fact that the current US administration can act more aggressively even while it goes against an agreement signed by its predecessor and remains mostly isolated on the international stage. This underlines the credibility of US sanctions and the reality that a similar situation could arise again.

This risk is not just hypothetical. Until recently, the US only resorted to secondary sanctions in cases involving relatively closed economies, such as those of North Korea, Libya, Iran, and Cuba. However, in 2017, Congress passed legislation that imposed secondary sanctions on Russia, including the country's energy sector. There is a real possibility that the

US will further expand this legislation through what some of its supporters call the “sanctions bill from hell”. This bill is meant to target the Russian energy and banking sectors in ways that present what former US official Richard Nephews calls a “real risk of secondary sanctions application”.

## Russia's goods trade with the EU and the US, 2017



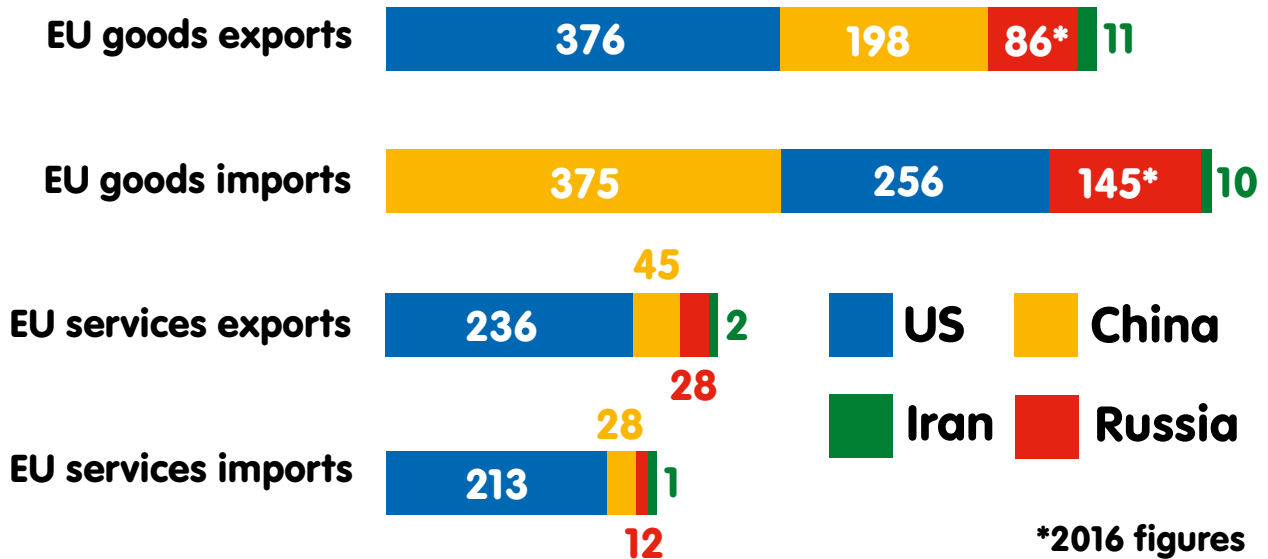
Meanwhile, OFAC has continued to add Russian entities to its list of targets of secondary sanctions. This can have a significant impact on European companies, as demonstrated by the unintended economic effects on commodities markets – and on European economic interests – of the inclusion on the list of firms linked with billionaire Oleg Deripaska, especially aluminium giant Rusal. Washington's focus on Moscow is particularly worrying for an EU that engages in roughly ten times more trade with Russia than the US does, and that includes member states that see the Russian-owned Nord Stream 2 pipeline as important to their energy security.<sup>9</sup> Recent US threats to disconnect Russia from SWIFT over its role in the Ukraine conflict have alarmed at least some EU member states.

Finally, the risk for Europe would not only be that of direct tension with the US. One can envision a scenario in which similar economic statecraft could be used against European interests by other powers, including those without the same level of economic and financial integration. China could try to leverage economic asymmetries or dependencies against Europe through trade restrictions (on, for example, products such as rare earths). Europeans should take this risk all the more seriously because China, while denying that it uses sanctions, already resorts to several types of coercive economic measure – de facto and informally, at least.

Europe would also be especially vulnerable to a sanctions war between great powers due to its reliance on the global economy and a rules-based international order. The EU may well have been naive to assume that this order and the economic relationships it underpins could be insulated from great power competition and coercive strategies.

<sup>9</sup> Comments from a senior EU official, January 2019.

# EU trade in goods and services, 2017 (€billion)



Source: European Commission

However, the EU must now recognise that persistent international tension over US sanctions and other extraterritorial measures – such as those that have been developed in the fight against corruption or financial crime, or to control foreign investments – can harm long-term European interests. Such a scenario would both lead to the fragmentation of the global economy and weaken collective security and multilateral cooperation, especially if most or all major powers began to use secondary sanctions.

## Building resilience against secondary sanctions

In this context, it is important for the EU to build up its deterrence and resilience against secondary sanctions, including by developing countermeasures that can act as a deterrent against them. This is necessary to minimise the impact of US secondary sanctions on Europe’s security and commercial interests. In the Iran case, EU governments have responded with firm statements that oppose US sanctions and reiterate their support for the JCPOA. They have also revived the 1996 Blocking Regulation to cover US secondary sanctions on Iran. EU unity on the issue, along with the launch of INSTEX, has frustrated the US administration, prompting it to attempt to divide member states. Yet all these steps have failed to affect the calculations of major European companies and banks. Overall, the measures EU countries have taken so far have not definitively protected European interests, nor been quick enough to suggest bold determination.

From the perspective of European policy, perhaps the most important effect of Washington’s increasing use of secondary sanctions has been to awaken the EU to the

dangers of such measures. As such, European countries are devoting greater resources than they once did to responding to US secondary sanctions. But while they all acknowledge the need to formulate a better response to the measures, they disagree on how much they are ready to pay for doing so, and on how to absorb these costs.

If the EU wants to be a global player on security and economic issues, member states must – in pursuing their strategic objectives – establish a process for sharing these costs and proving they have the will to resist secondary sanctions. Part of this involves sharing the costs across member states, to ensure that the US does not see, and therefore target, any one European country as confronting secondary sanctions alone. European decision-making on INSTEX demonstrates how this risk-sharing process can work: established in Paris, the mechanism is headed by a German and includes senior German, French, and British diplomats on its supervisory board.

As part of this effort, European countries must implement a road map that will eventually be credible enough to change the behaviour of European commercial actors. This will involve supporting European firms with clear measures that are sustainable in the medium term, to nullify the current impact of the asymmetries the US government exploits. Such measures should also seek to persuade the US administration to change the way it enforces secondary sanctions – making this an intergovernmental issue rather than leaving individual EU companies to face OFAC directly.

In responding to secondary sanctions, European governments and the EU should work with the kind of unity and purpose they displayed in resisting the Trump

administration's trade tariffs. Over time, familiarity with the process will ease European governments' concerns about the risks of angering Washington. This will gradually socialise the risk associated with secondary sanctions among European capitals. The EU and its member states should focus their medium-term responses to US secondary sanctions on the courses of action discussed below.

### *1) Enforce EU sanctions more stringently*

There are some important differences between the ways in which the US and the EU use sanctions. The US takes a more expansive approach and adopts a more aggressive enforcement policy. The EU generally resorts to relatively limited sanctions – fewer regimes, comprehensive provisions, and designations – and, in parallel, usually sustains its diplomatic efforts for more than just coercive purposes. While Europe considers its sanctions to be more politically minded, targeted, and reactive, the US regards them as ineffectual.

In particular, the US administration considers Europeans to be weak on enforcement. Some US officials have commented that they struggle to find a major case in which European governments or courts have enforced EU sanctions on European companies.<sup>10</sup> It is true that, on the whole, Europe's systems for implementing and enforcing the measures are less developed than their US counterparts, and this is not just because of the division of labour between the EU and national levels.

Indeed, the EU system for implementing and enforcing sanctions relies on member states: the European Commission is tasked with monitoring the uniform implementation of sanctions in the EU and supervising their enforcement. And, as officials are quick to point out, the EU has a different culture in punishing entities that breach its sanctions. In Europe, enforcement action takes place in a more restricted and less public manner than in the US – which usually seeks to name and shame sanctions-evaders.<sup>11</sup>

Still, as ECFR has confirmed in interviews on both sides of the Atlantic, the US believes that Europeans are not properly enforcing their own sanctions. The EU will not be able to address the challenge of secondary sanctions without tackling this deeper transatlantic credibility problem. Some European leaders, such as the French finance minister, have recognised this and suggested that the EU should establish a European equivalent to OFAC.

In theory, such an organisation could significantly improve oversight of sanctions enforcement in Europe, while acting as OFAC's main interlocutor on secondary sanctions.

But it will be very difficult for the EU to create its own version of OFAC. The EU is built on the subsidiarity principle, which makes national governments rather than the union responsible for the enforcement of sanctions. And,

politically, member states are unlikely to relinquish what they see as a core function of national sovereignty. However, EU member states could develop their own version of OFAC along the lines of the pan-European enforcement authority to combat money laundering that some of them recently called for. Member states could also create a pan-European organisation to help European companies respond to secondary sanctions imposed by third countries.

In any case, there is a need to build more consistent and credible EU mechanisms for sanctions implementation and enforcement: member states could authorise the European Commission to improve coordination between national authorities on this. This effort could help the union deal with the implementation of US sanctions when it affects European companies. It could also provide EU institutions with a more comprehensive overview of the measures and help them put the union's combined political and economic weight behind exchanges with the US authorities, thereby lending credibility to the deterrent Europeans should aim to establish (as discussed below). A similar approach proved effective in pressing the Trump administration to lift congressional sanctions on Rusal.<sup>12</sup>

### *2) Develop mechanisms to minimise the impact of US secondary sanctions*

#### ***Improve the credibility of INSTEX***

In response to Washington's secondary sanctions, European countries have looked to establish an SPV that circumvents the traditional financial networks the US uses to establish its jurisdiction for enforcing sanctions. INSTEX has been created to be that vehicle. If it proves to be a viable mechanism for trade with Iran, INSTEX could eventually act as the keystone of a European trading system that runs in parallel to conventional, US-connected routes – thereby providing an alternative for European companies that wish to remain in markets targeted by US sanctions.

Much hard work is still needed to ensure that INSTEX works in the long term, which implies an operational counterpart structure on the Iranian side (one that abides by international financial norms on money laundering and terrorist financing). The mechanism will only be workable if European banks are willing to cooperate with it to move funds in European territory. Moreover, there must be a sufficient number of European trading actors that are willing to use it. Unlike China and Russia, Europe does not want to force its companies to use these facilities but rather to provide them with greater freedom to decide which markets they operate in.

For now, INSTEX has narrow ambitions, with an initial focus on what European officials call “the sectors most essential to the Iranian population – such as pharmaceutical, medical devices and agri-food goods”. Widening its scope beyond trade permissible under the US sanctions framework would run the risk of placing INSTEX on the United States' SDN

<sup>10</sup> Interviews with former US Treasury officials, November 2018-March 2019.

<sup>11</sup> Comments from an EU official, June 2019.

<sup>12</sup> ECFR interview with a senior European official engaged in the process, January 2019.

list. And there is already a threat of designation given that the US could find fault with European due diligence on, for instance, the nature or final beneficiary of these transactions. Still, the scope of trade under INSTEX is too narrow. Therefore, European leaders should view the current version of the mechanism as a base on which to expand.

European governments must be prepared to take the risk that the US will target INSTEX, as well as companies that will be connected to it, with sanctions. Although national governments' support for INSTEX provides a high degree of protection, the US could still apply sanctions to traded goods as much as to the financial flows used to pay for them.<sup>13</sup>

One important factor in avoiding this, and in INSTEX establishing its international credibility, will be whether most, if not all, EU member states join the mechanism. Pan-European involvement in INSTEX would help socialise the risks associated with it. Eventually, companies from other nations could also use it. States such as Russia and China – as well as India, Turkey, South Korea, and Japan – have expressed interest in collaborating on such a mechanism.

### ***Create other parallel financial channels with limited exposure to the US***

Beyond expanding INSTEX, EU countries should consult one another on the costs and benefits of creating a new financial system that runs in parallel to existing frameworks. So far, there has been no such initiative in Europe. Despite receiving the support of the European Commission, the European Investment Bank also declined to deal with Iranian business, out of concern that this would hamper its ability to access US capital markets. Similarly, French state-owned bank Bpifrance initially declared that it would establish this type of financial mechanism, but eventually decided not to proceed with its plan. According to one Bpifrance representative, it was possible to insulate the bank's transactions from US primary sanctions, but companies engaged in a specific transaction involving Iran would find it much more difficult to eliminate their exposure to the US, and Bpifrance itself could have been shut out of US financial markets.

The Chinese have essentially developed a dual banking system, which allows them to direct one set of banks to work with the US and another to deal with countries subject to US secondary sanctions. But, even in China, the deterrent effect of the latest US secondary sanctions can be felt, and Chinese banks and other companies act with caution given the prudent approach Beijing takes to the issue, to avoid damaging sensitive trade negotiations with the US.

Regardless of whether such a dual system had been established, parallel payment channels – which might involve a fully developed INSTEX – could at least give companies the option of choosing between markets. This approach would also provide protection to individuals who are currently exposed to the effect of US secondary sanctions through US-owned credit card and other electronic payments systems.

<sup>13</sup> ECFR interview with a former US official involved in sanctions policy on Iran, December 2019.

### ***Protect SWIFT***

SWIFT has quickly become so important that disconnection from it is, as Joanna Diane Caytas argues, “the financial market equivalent of crossing the nuclear threshold, due to the vital importance of the embargoed services and near-complete lack of alternatives with comparable efficiency”. In the context of US sanctions, there is much talk in Europe (both among experts and within government circles) about creating an independent replica of SWIFT. As a European entity operating under Belgian law, the organisation has some independence. But the Iran case has shown that US policy retains an overriding influence on it and its staff and board members.

European countries have frequently discussed the idea of establishing an alternative to SWIFT that benefits from the same kind of governmental backing provided to INSTEX. But creating an alternative to SWIFT would be a lengthy process; the time would be better spent devising ways to protect the existing system.

As a relatively soft step towards protecting SWIFT, European countries could push for an agreement between members of the International Monetary Fund to preserve the independence and political neutrality of financial messaging services such as SWIFT. European governments should make the case that SWIFT's systemic importance to global trade makes it worthy of special protection. Such an international pact should state that SWIFT will not be restricted by any unilateral measures, even justified on the basis of national security. An exception could be made for banks subject to UN Security Council sanctions.

Another measure would be for Belgium to use the Blocking Regulation in relation to SWIFT by insisting that banks subject to US secondary sanctions remain connected to the system. But a more effective use of the regulatory provisions would be for the European Commission to draft a new iteration of the Blocking Regulation that prevents financial mechanisms in Europe from complying with a third country's secondary sanctions. This would leave no room for doubt about EU legislation, forcing European entities to comply with it. Such an approach would be an effective form of *ex ante* financial regulation. For example, it could pre-empt Washington's introduction of further restrictions on SWIFT vis-à-vis connections with Russian or Chinese banks. Here, Europeans could leverage SWIFT's central role in global banking to, essentially, test the United States' willingness to sanction the organisation and its board members. Given the importance of the services SWIFT provides, the prospect of severe harm to the US banking sector could act as a powerful deterrent. By taking up such a defiant position, the EU would make it much more difficult for the US to implement secondary sanctions on SWIFT.

A more aggressive approach would be for the EU to press Belgium to nationalise SWIFT – or, at least, to threaten to do so should the US impose draconian sanctions on the



organisation. As it stands, the EU is reluctant to make the threat because of the likely political fallout in transatlantic relations, the possible need to compensate banks affected by nationalisation, and the damage the process would do to confidence in European markets and the rule of law. Moreover, such a threat might prompt the US to create its own alternative to SWIFT. Nonetheless, the centrality of the organisation to European economic interests justifies a healthy debate on various options.

### ***Expand the role of central banks***

Regardless of the method Europe chooses to counter secondary sanctions, the Iran case illustrates just how difficult it can be to restore financial connections on a large scale. Even during 2015-2018, when the US was party to the JCPOA, its ambiguous policy on sanctions relief preserved extensive blockages in European banking connections with Iran. The failure prompted European leaders to briefly consider the idea of directly connecting European central banks to Iranian entities.<sup>14</sup> They returned to the concept after the US withdrew from the JCPOA, hoping that the public status of these institutions would help shield the transactions.

For both financial and political reasons, no one central bank wants to be the first to test the theory. However, European governments should thoroughly consider the role that central banks can play in facilitating trade with entities targeted by US secondary sanctions where the political and economic stakes are high.

To ensure the approach is technically workable, European central banks would need to make fundamental changes to the way they operate. One way to involve central banks would be to establish special commercial accounts for European companies that trade with entities subject to US secondary sanctions. To do so, they could build upon existing practices and structures most central banks already use to hold accounts for their staff, as well as for some non-profit organisations and public organisations.

A central bank with this type of account could then receive funds from an entity sanctioned by the US and – rather than transferring them through the commercial banking system – deduct the amount from the debts to governmental authorities (such as taxes and social security) owed by that entity's European trade partner. This mechanism would contain the direct flow of funds, and thereby the associated risks, within public institutions.

### ***Reduce denial of services between European entities***

While it served as a useful political signal, updating the 1996 Blocking Regulation has not proved effective in countering the impact of US secondary sanctions. Most of the European companies and legal experts interviewed for this paper did not believe that European countries would enforce the Blocking Regulation. Indeed, in its research, ECFR was unable to confirm whether any EU member state had opened

investigations into, or imposed penalties on, European companies that left the Iranian market due to US secondary sanctions – as the companies did not wait until the US had begun procedures against them before making these decisions. Thus, commercial actors have opted to abide by, and even over-comply with, the US sanctions framework.

A more realistic course would be to change the behaviour of European entities through trade that is permissible under US sanctions. One way to do so is for the European Commission to strengthen existing measures, and to investigate instances in which a European entity makes a reasonable case that it has been discriminated against or denied services by another European entity on the basis of US secondary sanctions. The process of opening investigations into some companies' decision-making processes and compliance protocols could help change calculations in firms' boardrooms. This effort should aim to reduce the number of instances in which European banks over-comply with US secondary sanctions in transactions related to humanitarian trade, as well as other trade permissible under US sanctions.

### ***Account for disruptive technology***

Facing major barriers to international banking, Iran has in recent years begun to experiment with financing some transactions using hard-to-trace bitcoin. This type of currency, which operates via blockchain and thereby bypasses commercial and central banks, has opened the way for some SMEs to trade with their counterparts in Iran. The US Treasury has attempted to impose restrictions on these transactions, including by sanctioning traders and preventing Iran-based buyers and sellers from using some trading platforms. Nonetheless, it is currently difficult to systematically regulate or effectively sanction cryptocurrency traders, as they operate through a decentralised system.

To encourage greater use of cryptocurrencies, Iran's government and central bank are attempting to provide an attractive market for companies that mine bitcoin. Russia, Venezuela, and North Korea have also done so, in the hope that this will allow them to evade US sanctions.

Yet, for all the hype about cryptocurrencies, there are significant limitations to their use. Countries under sanctions may find it difficult to back their own cryptocurrencies: the supply of bitcoin and other non-state currencies is tiny in comparison to that of US dollars currently in circulation, and there are relatively few opportunities to convert cryptocurrencies into a state-backed currency. More importantly, most cryptocurrencies are pseudonymous rather than completely anonymous and, therefore, the long arm of US sanctions will eventually reach those who use them.

There are also major regulatory and transparency questions about the use of cryptocurrencies. European governments remain concerned about the dark commerce and money laundering networks that they facilitate. Yet it is possible

<sup>14</sup> ECFR interview with a senior European official, January 2019.

that a major technological disruption to sanctions policy will come from innovation in blockchain and other distributed ledger technologies.

As discussed above, the United States' capacity to impose sanctions on foreign entities largely stems from its role as a gatekeeper in international finance – its ability to impose its jurisdiction based on its centrality to the global system. Therefore, decentralised technological innovations in the financial sector could, by assisting efforts to create parallel payment channels, pose a serious challenge to the US. European governments should actively consider how such blockchain technology can be integrated into efforts to create alternative payment channels that have minimal exposure to US secondary sanctions but fall under the purview of EU regulation.

### *3) Strengthen the euro as a viable alternative to the dollar*

The technical solutions outlined above can only truly improve European resilience against secondary sanctions if the EU significantly strengthens the global role of the euro. Benoît Cœuré, a member of the European Central Bank's governing board, has stated it is imperative that Europe raise the “global standing” of the euro, using the currency as “a tool to project global influence”. Although this is not the only rationale, he has directly linked this goal to the issue of US sanctions, noting that “being the issuer of a global reserve currency confers international monetary power, in particular the capacity to ‘weaponize’ access to the financial and payments systems”.

The EU is not the only major power that aims to bolster its currency in the hope of one day competing with the US dollar. Moscow's attempts to set up an electronic payments system to rival Visa and Mastercard, as well as its own financial system, have been significantly hampered by the weakness of the Russian rouble, which has prevented its efforts from gaining much traction with major commercial actors. Meanwhile, China has sought to elevate the renminbi by establishing a system for making oil trading payments in the currency, setting up foreign exchange agreements with other nations, including Russia, and encouraging the use of its currency in infrastructure projects under its Belt and Road Initiative. China too has faced limits to its ambitions, as a result of its high debt levels and the overall slowdown in its economic growth, among other things.

The good news for the euro is that it remains unchallenged as the second-most-important currency in the international monetary system, after the US dollar. And there have been a series of calls for the euro to assume a stronger international role. But the euro still has several disadvantages relative to the dollar. For a start, the share of global trade in US dollars is far higher. And the dollar plays an important role in EU countries' trade: member states pay 80 percent of their energy import bills in dollars, even though just 2 percent of their energy comes from the US. Moreover, exchanges between euros and a third currency often involve the dollar in an intermediate stage.

Lastly, as one European Central Bank official has noted, the list of factors that “prevented the euro from rising more forcefully as an international currency” include Europe's tendency not to speak “with one voice on international matters, including national security”. Factors specific to the euro area are also likely to have prevented the euro from rising more forcefully as an international currency.

The main obstacle to much-needed reforms is EU countries' unwillingness to implement the painful measures required to internationalise the euro. There is an emerging consensus among EU institutions, beginning with the European Commission and the European Central Bank, on the need to be more ambitious with the euro – but some governments maintain their traditional reluctance to act.

There are no quick fixes for the euro. Leading European economic powers such as France and Germany will need to agree on how to strengthen and deepen the Economic and Monetary Union, to increase the stability of – and, therefore, trust in – the euro. There is also a need to address the inconsistency between current account surpluses and the bigger global role of the euro.

Moreover, the EU will need to provide incentives to develop low-risk assets denominated in euros, such as European bonds. The strongest euro-denominated investments come from German bonds. These are in short supply due to the German government's reluctance to finance spending with debt acquired through the sale of bonds. In combination, these measures could create more liquid capital markets, reducing Europe's dependency on the US dollar and thereby limiting its exposure to US sanctions.

Still, even if the euro gains strength globally, it will not replace the dollar but rather coexist with it in a more multipolar monetary system for many years to come.

European countries are now beginning to realise how much they would benefit from reduced dependence on the dollar. Such a shift is already a point of concern for the US. In 2016 Jack Lew, then US Treasury secretary, warned: “the risk that sanctions overreach will ultimately drive business activity from the U.S. financial system could become more acute if alternatives to the United States as a centre of financial activity, and to the U.S. dollar as the world's preeminent reserve currency, assume a larger role in the global financial system.”

### *4) Adopt asymmetric countermeasures*

EU member states should engage in a serious debate on how to use the mutual dependency of Europe and the US to raise the costs for the US of enforcing its secondary sanctions. For instance, where the US threatens to fine a European company or cut it off from its markets, the EU could respond by targeting US companies' access to specific European markets. Or it could freeze the assets of US firms in proportion to the penalties imposed by the US Treasury.

One way would be for the EU to create its own extraterritorial measures that can be imposed on US interests. Indeed, the Trump administration's policy on Iran has already prompted a discussion on this issue. The union should not adopt secondary sanctions but rather develop a capacity to use countermeasures – ideally, for deterrence purposes only. Yet the EU would need to establish a formal legal process for such countermeasures.

In “weaponising” asymmetries in its economic relations, the union would not have to take a more expansive approach to establishing its legal jurisdiction.

## Dispute settlement at the WTO

Challenging US secondary sanctions at the World Trade Organization (WTO) could be one way to counter the US position, but so far this has been put on hold for three reasons. Firstly, dispute settlement at the WTO is a lengthy process.

Secondly, and more importantly, current tension around the organisation makes it perilous to add to the list of grievances the current US administration may have against it, particularly dispute settlement mechanism.

Thirdly, there are concerns in some European quarters that a case against US secondary sanctions could produce a backlash against sanctions in general, including the ways in which the EU uses them. Still, this should not be totally discarded in the context of discussions with the US. After all, the US administration itself has brought new cases to the WTO since the Trump administration came to power. And, in any case, there are already active cases in which the scope of the “national security exemption” will be litigated. The US administration's April 2019 decision to end the waiver on sanctions related to Cuba under the Helms-Burton Act could eventually help prompt the EU to sue the US at the WTO.

The EU already has a credible track record of using economic clout to impose its preferences on foreign entities, as seen in its enforcement of established competition standards and measures such as the General Data Protection Regulation.

Similarly, to protect core European strategic interests, the EU could leverage access to European markets in ways that would deter the US from imposing secondary sanctions on European entities when they undermine core European strategic interests.

The EU could, for example, require foreign banks operating in Europe to apply for licences that it could revoke if they comply with secondary sanctions on European entities – at least, where such compliance adversely affects the European banking sector. The EU could also leverage access to its market in relation to norms and constraints on environmental protection, data privacy, and other issues

where there is a considerable divergence between EU and US practice.

Of course, these instances of divergence deserve to be dealt with on their own merits, not just as a bargaining chip in negotiations on sanctions policy. But the EU could certainly ensure that, in its attitude to sanctions, it is only as accommodating as the US is willing to be. By enforcing such countermeasures, Europe could gain leverage in negotiations with the US.

Such steps would show that US-EU dependence is mutual, thereby rebalancing the sides' relationship. At a time when WTO mechanisms seem unlikely to help settle such a dispute (see box), the use of countermeasures is a valuable route to push for a negotiation that the US has so far refused.

Some EU member states may object to this kind of assertiveness. Yet the union has become comfortable with implementing – and threatening to implement – countermeasures in trade disputes. And it has proved effective at doing so – as seen in its success in resisting some of the Trump administration's planned tariffs without damaging transatlantic relations, which helped reopen negotiations between the sides. The approach could be equally effective in dealing with secondary sanctions.

As discussed above, greater European assertiveness would not entirely counteract US secondary sanctions, but it would raise the costs of enforcing them. The extent to which some member states resist EU countermeasures against secondary sanctions will depend on the country that has been targeted. For example, there is likely to be greater European disunity on Russia than on Iran (so long as the JCPOA is being implemented). To overcome this hurdle, a coalition of willing member states should take the lead in persuading less committed countries that devising a more integrated EU process for countermeasures against secondary sanctions is vital if Europe wishes to be a leading economic player.

### *5) Lead a global dialogue on the use of sanctions*

Amid growing divergence in how global powers adopt and enforce sanctions, Europe could lead the way in calling for both a transatlantic dialogue and a more global discussion on resolving their differences over the measures. At the transatlantic level, Europe should clearly outline the dangers of the current situation, while calling for greater strategic cooperation on sanctions. It should also make a sober assessment of how the last three decades of sanctions have affected the behaviour of target entities such as Iran, North Korea, and Russia. The need for such a transatlantic dialogue has been apparent since the Obama era – if only in relation to issues such as SWIFT, technical definitions, and legal instruments (including licences and letters of comfort).

This EU-US dialogue would also create an opportunity for a more political discussion. Europeans should underscore Lew's warnings that “secondary sanctions should be used only in the most exceptional circumstances, where – as with Iran – the threat is severe, where we have international

consensus, and when ordinary sanctions have fallen short of their mark". Europe should stress the need for international cooperation on sanctions, to increase their effectiveness where states have shared policy interests. But it should also warn against the use of secondary sanctions as a means of coercion where these interests diverge, and/or in the absence of multilateral backing.

A more global dialogue could eventually lead to the creation of an international framework for regulating the use of international sanctions, not just between G7 countries (which have traditionally held narrow consultations on sanctions issues) but also with other powers such as Russia and China. These other powers not only have to implement and enforce UN sanctions but also resort to more or less informal sanctions on a national basis. While the dialogue should begin as soon as possible, it will most likely require the advent of a new US administration to produce tangible results.

Until then, Washington will only change its position on the use of secondary sanctions if they begin to not just impose greater costs on its strategic, particularly economic, relationships with key partners but also threaten its interests more directly in the ways outlined above.

## Europe's political will

European countries need to prepare for a steady increase in the use of sanctions and other economic measures in international relations. Economic asymmetry and interdependence will sometimes work against Europe – and not only in its relations with the US. As a consequence, the EU should hedge against countries' desire to exploit them. It could do so by, for instance, diversifying its international relationships and enhancing its own economic dynamism to avoid excessive dependence on any one power; reinforcing member states' collective ability to take countermeasures against economic coercion; and establishing compensation mechanisms for European entities hit by sanctions.

Europe should treat the steps discussed above as a mixture of medium- and long-term measures. Strengthening the credibility and organisational structure of the EU's sanctions policy, reinforcing the euro's international status, and leading a global – particularly transatlantic – dialogue on sanctions will remain useful beyond the current disagreement between Europe and the US over the JCPOA, as they are central to other strategic issues. Meanwhile, European governments should resort to asymmetric countermeasures only in an ad hoc fashion, in response to significant threats to its interests.

For the EU, there is no panacea for US secondary sanctions. Rather, the issue is how to persuade the US that escalating its sanctions dispute with European countries is not in its interests. Member states need to show that they are willing to use countermeasures against the US if it does not change course – even where they disagree on the technical aspects of these countermeasures. Credibility and determination are key to this, as is the aim of improving transatlantic

cooperation or, at least, containing the effects of current sanctions and preventing escalation.

European capitals must be prepared to act on their rhetoric. In any case, they should avoid sending mixed signals to the US and other powers. Unfortunately, this is exactly what they have sometimes done. For example, after promising to establish INSTEX, they appeared weak in taking months to agree on which country would host the mechanism. The European Investment Bank's refusal to make investments in Iran, after EU diplomats suggested that it should take on that role, only reinforced this impression. Even if it is unlikely to play a central role in settling the transatlantic sanctions dispute, the Blocking Regulation has suffered from a lack of high-profile cases of its enforcement – and, even more importantly, some countries' failure to transpose it into national legislation. Due to this seeming indecisiveness, neither European companies nor the US authorities take the EU seriously on sanctions.

Unity between Europeans will also be key to changing the EU's international image. In the context of Brexit, it was important that the United Kingdom stayed in close alignment with France and Germany in setting up INSTEX – especially given the central role that the three countries play on the JCPOA. The EU will be stronger in its negotiations with the US if it can keep the UK on side in dealing with secondary sanctions. More broadly, establishing a consensus within the EU is indispensable to both sending credible political signals and adopting the kind of measures suggested in this paper. Tension with the US on security guarantees, trade interests, and other issues will test European countries' unity, particularly given their differing threat perceptions and priorities.

To robustly respond to US secondary sanctions while maintaining internal unity, the EU must create an acceptable level of shared risk. A coalition of large European countries must demonstrate the political will to accept and share the costs of the response for the transatlantic relationship (at least temporarily). Europe will need to create a clear road map for responses it can make in the short, medium, and long term to minimise the damage of future US secondary sanctions. This need not begin with grand, revolutionary steps but rather those such as operationalising INSTEX.

Some of the steps proposed above may seem partial, at best, in their ability to offset Europe's vulnerability to secondary sanctions. But some US experts are increasingly concerned about how the overuse of sanctions could affect the United States' global financial dominance in the long term. These concerns, which Obama-era US officials also shared, have only been amplified by Trump's maximalist sanctions policies – especially, but not only, in the case of Iran. Europe should emphasise these concerns in discussions with the Trump administration and Congress, as well as with interlocutors who may play a role in the next US administration. This approach will carry greater weight in combination with a credible threat that Europe will impose painful costs on the US for enforcing secondary sanctions on European companies.



Europe's mission should not be to reverse the process of integration and globalisation that it and the US have long championed. Instead, it should be to find a more equal transatlantic footing, on which Europe's interests and positions become a serious factor in bargaining with the US over foreign policy and trade priorities. In sanctions policy, the overarching objective for European countries should be to change their mindset and internal narrative on

their collective ability to respond to these measures, with a view to retaining control of their strategy and foreign policy.

The US has set unilateral rules on secondary sanctions in ways that abuse its global financial dominance. It is time for Europe to better preserve the multilateral order by drawing its own red lines.

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