



## 21-1 Raising a Caution Flag on US Financial Sanctions against China

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For many decades, the United States has used economic sanctions to pressure global adversaries. The practice accelerated in the Obama and Trump eras, directed against foreign governments and officials, their proxies, and various nonstate actors, including those accused of nuclear weapons proliferation, terrorism, and human rights abuses. Trade sanctions used to be the main pressure point, but recently the United States has imposed financial sanctions that freeze the US assets or bar US entry of the targeted individuals and firms and prohibit US financial firms from doing business with them. These measures often punish but do little to prevent or change foreign practices, because most of the individuals and firms subject to sanctions have limited exposure to the US market and global financial institutions.

A new test of the potential effectiveness and dangers of financial sanctions is in the offing as tensions with China rise over its crackdown on Uighurs in Xinjiang and suppression of freedoms in Hong Kong. Bipartisan pressure is growing to tighten the screws on Chinese leaders and firms via new financial sanctions. Targeting major state-owned enterprises (SOEs) and major financial institutions that do business with China is the likely next step (and is authorized in recent US statutes). To date, US officials have implemented this high-stakes strategy only against Iran. Targeting China would be far more consequential.

Before imposing punitive sanctions on major financial institutions engaged with China, US officials should carefully weigh the risks to international financial markets and US economic interests more broadly. By restricting access of major banks to international payments in US dollars and barring use of messaging systems like the Society for Worldwide Interbank Financial Telecommunication (SWIFT), tougher US financial sanctions would effectively “weaponize” the dollar; friends and foes alike would be pushed to seek alternatives to dollar transactions that, over time, would weaken the international role of the dollar. European countries have already established a new channel to circumvent US financial sanctions, the Instrument in Support of Trade Exchanges (INSTEX), which has supported non-dollar transactions with Iran for medical supplies but otherwise has not yet attracted other business.

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As the incoming Biden administration begins its review of US sanctions policy, it should exercise caution on new financial restrictions. Instead of doubling down on current unilateral financial sanctions, US policy should deploy sanctions in collaboration with allies and calibrate trade and financial controls to match the expected policy achievements. US officials should avoid measures that cause substantial disruption to trade and financial markets if the target is unlikely to change its policies, instead pursuing coordinated sanctions policies along with strategic countermeasures (e.g., subsidizing R&D, increasing national strategic stockpiles) that offer more constructive responses to foreign outrages.

## PAST IS NOT PROLOGUE

US sanctions are designed to influence foreign behavior in support of US foreign policy goals. Sanctions provide a concrete US response that goes beyond the polite rebukes of diplomatic notes or joint resolutions of Congress but avoid the harsher consequences of deploying military force.

Sanctions check off an important box for US officials, demonstrating to the US public that they are doing something to respond to foreign misadventures and punish responsible officials in the target country and their cronies most directly involved in the episode. If the US administration does not act rapidly enough, members of Congress are at the ready to pass legislation setting out a menu of sanctions to be deployed over a specified period. Country-specific sanctions legislation took root during the 1980s to spur President Reagan to act more aggressively against the apartheid regime of South Africa and later with regularity to counter policies of the Iranian, Libyan, Iraqi, and Syrian regimes, among others. These country-specific laws complement the massive arsenal of authorities that Congress has delegated to the US executive under the Trading with the Enemy Act of 1917, the Export Administration Act of 1969, the International Emergency Economic Powers Act of 1977, and other acts.

Use of sanctions for these purposes has a long history, as documented in the landmark PIIE study, *Economic Sanctions Reconsidered*. The third edition of that work, first published in 2007, examined the large number of US sanctions episodes in the 20th century.

In past decades, US officials used trade and financial sanctions to squeeze the economies of target countries to coerce them to change their evil ways. US sanctions relied heavily on trade embargoes or blocking loans to punish target countries. These blunt penalties often hurt the poor and neighboring countries but did little to impede the target's ruling class or reverse its odious policies. Import embargoes and export bans caused, and still cause, massive economic disruptions in target countries. In addition to trade measures, some sanctions cases also involved the withholding of financial aid to the target country or deterred lending by international financial institutions.

In most cases, the ruling classes could isolate themselves from economic harm and deflect the pain to the general population (and then blame the United States for the deprivation). The poor got poorer, as sanctions constrained production and employment and created shortages that fed inflation. But the regime usually insulated itself from hardship and used the economic woes to

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rally public support against the United States. Such “rally ‘round the flag” effects bolstered the target regimes in Cuba, Venezuela, Iran, North Korea, and many other countries.

Has the deployment of economic sanctions achieved or even advanced US foreign policy goals? Sanctions do not operate in a vacuum, so the PIIE analysis defined success more flexibly as contributing to at least the partial achievement of the stated foreign policy goals (recognizing as well that sanctions are also used for domestic political reasons). On that albeit subjective standard, PIIE analysis found that sanctions episodes “worked” in about one-third of all cases, generally those with modest ambitions to change minor policies of the target regime. Financial sanctions were generally more effective than trade measures, although they were often used in combination. The most notable success story was the contribution of sanctions to the downfall of the South African apartheid regime. More recently, comprehensive US and EU sanctions pressured Iran to negotiate significant constraints on its development of nuclear weapons under the Joint Comprehensive Plan of Action (JCPOA) signed in July 2015.<sup>1</sup> Most other postwar wins came in low-stakes cases against small countries.

Sanctions episodes usually targeted small, trade-dependent economies in which trade and financial controls could be highly disruptive and coerce compliance with the demands of the sanctioning countries. Many targets had resource-dependent trade profiles (Iran, Iraq, Libya, Russia). Even in these cases, however, the sanctions generally did not suffice to change behavior.

After 60 years of US sanctions, Cuba remains defiant. Despite a suffocating embargo, the US Marines needed to invade Panama in 1989 and oust its dictator, Manuel Noriega. Getting rid of Saddam Hussein, hit with the most comprehensive economic embargo in the postwar era, required a major invasion, because the Iraqi henchman was able to smuggle in billions of dollars of goods despite the sanctions. Iran and North Korea remain committed to developing nuclear weapons despite the debilitating impact of US sanctions on their economies. And Russia remains unrepentant and unconstrained, in part because sanctions against it in response to Putin’s takeover of Crimea and parts of eastern Ukraine have been half-hearted and the United States has remained half-blind to the economic and military assistance Putin has provided to keep Nicolás Maduro in power in Venezuela.

Even when sanctions “worked,” success came at a cost in terms of damage to the target economy (and often collateral damage to its neighbors), complicating the task of restoring viable economic and political institutions once the sanctions were lifted. Most troubling has been the humanitarian hardship that sanctions inflicted on the poorest segments of society.

To reduce collateral damage, about 25 years ago US policymakers began to experiment with “smart sanctions,” which seek to apply economic pressure more directly against bad actors in government and society and leave the general population relatively unscathed.<sup>2</sup> These sanctions required pinpointing

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1 The success was short-lived, however. The Trump administration claimed that the JCPOA was fatally flawed because key obligations undertaken by Iran were time limited and the pact did not require rigorous dismantling of existing weapons of mass destruction capabilities, among a litany of reasons, and it pulled out of the deal in 2018.

2 Comprehensive countrywide sanctions still are applied against Cuba, Iran, North Korea, and Venezuela.

economic measures to specific individuals or sectors of economic activity—often via financial and travel restrictions—that were “designated” by the US Treasury Department.<sup>3</sup> With limited tools to exercise this targeted policy, smart sanctions initially were simply constrained actions that took account of collateral damage.

Unfortunately, the vision of smart sanctions was a mirage. Despite the flurry of activity and the mounting number of designations, the smart new financial measures have generally been as ineffective as the old-style trade and investment embargoes, and foreign abuses continue unabated. The failures have prompted officials to consider stronger doses of economic shock to short-circuit the financial networks of target countries.

Over the past two decades, financial sanctions have become much more potent. Advances in financial and information technologies have allowed sanctioning officials to focus their weapon with laser-like precision and to clog the financial pipelines of a country to limit circumvention of the prohibitions on financial transactions with designated firms. Individuals or firms that violate the sanctions risk not only hefty fines but possible bans on transactions with US financial institutions. Over the past decade, major banks have been [assessed substantial penalties](#) and fines for “egregious violations” of US sanctions, but none has been barred from the US market.<sup>4</sup> Bank and nonbank entities spend billions of dollars to monitor compliance and avoid dealings with those on the Specially Designated Nationals and Blocked Persons List (SDN) that are targeted by US sanctions.

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### THE SDN LIST: A MACRO REGISTRY OF MICRO SANCTIONS

The Office of Foreign Assets Control (OFAC) of the US Treasury [administers 35 programs](#) targeting country-specific problems and countering terrorism, cyber-related crimes, human rights abuses, nuclear proliferation, and narcotics trafficking. It compiles the SDN list, which catalogs people and firms engaged in or responsible for specific abuses and ships and aircraft used in illicit activities. The SDN list now runs more than 1,500 pages and includes more than 6,000 names.<sup>5</sup>

Being on the SDN list is consequential. US sanctions are meant to punish the people and firms engaged in abusive practices and to deter the continuation or emulation by others by restricting their financial relationships with US nationals. These targeted financial measures include banning equity and debt investments, transactions in foreign exchange, and transfers and payments by banks subject to US jurisdictions and freezing assets within US jurisdiction. These so-called primary sanctions effectively prohibit US nationals from doing business with and block all of the US assets of firms or individuals on the SDN list.

<sup>3</sup> For an early analysis of “targeted” or “smart” sanctions, see [Hufbauer and Oegg \(2000\)](#).

<sup>4</sup> BNP Paribas paid nearly \$9 billion in penalties and fines in 2014 for evading US sanctions that proscribed financial transactions on behalf of firms in Iran, Cuba, and Sudan. The US Treasury also imposed heavy fines on HSBC, Standard Chartered, ING Bank NV, and Barclays, among others.

<sup>5</sup> In recent months, US officials have added individuals and entities from Belarus, China, Iran, Syria, and Venezuela among others to [the SDN list](#).

Some sanctions also punish non-US nationals who do business with firms or individuals on the SDN list (secondary sanctions). These sanctions target not only bad actors but also their customers, bankers, and insurers, as well as the ships and planes used to transport illicit goods. Some of those collateral targets are US friends, provoking protests from allies whose citizens and firms are the target of the extraterritorial enforcement of US policy. The imposition of these sanctions complicates the task of building international coalitions to support US sanctions policies and at times has provoked foreign countries to implement blocking statutes to deter local firms from complying with US sanctions.

Maintaining and updating the SDN list is a big job. It consumes substantial government resources that could be better deployed in preventive actions or other policies that could affect target economies and encourage foreign governments to alter their policies. Coupled with the vast sums spent by firms to self-enforce US sanctions regulations, these micro sanctions have become a very costly exercise of foreign policy.

Over the 2010-19 period, OFAC added more than 7,000 individuals, entities, and transport vessels and aircraft to the SDN list while delisting more than 3,000 (some of which were later redesignated after the US withdrawal from the Iran nuclear deal), according to the [Center for a New American Security](#). On balance during 2010-19, the SDN list added 1,950 individuals, 1,708 entities, and 431 vessels and aircraft that transport sanctioned goods (table 1).

**Table 1**  
**New SDN designations, by type, 2010-19**

Type	New designations	Delistings	Net change, 2010-19
Individuals	3,045	1,095	1,950
Entities	3,306	1,598	1,708
Vessels and aircraft	815	384	431
Total	7,166	3,077	4,089

Source: Center for a New American Security, [www.cnas.org/publications/reports/sanctions-by-the-numbers](http://www.cnas.org/publications/reports/sanctions-by-the-numbers).

It is difficult to derive total data by country across the 35 sanctions programs, but the OFAC sanctions search engine allows a first-approximation. Not surprisingly, the largest number of designations by far target Iran, followed by Syria, Ukraine, North Korea, Venezuela, and Russia (table 2). The SDN list covers over 1,600 individuals and 1,900 entities in recently targeted countries. About 20 percent of the entities are banks, including the central banks of Iran and Venezuela (and the Central National Bank of the Donetsk People's Republic [eastern Ukraine]). Most of the banks on the SDN list are minor players with limited holdings. They include a few relatively small banks in China linked to sanctioned transactions with Iran and North Korea, including the Gorgeous Bank of North Korea (really!). Some, however, such as the Russian Bank Rossiya, are intimately connected with the ruling elite in the target country. Except in Iran, where most banks are now designated, the US sanctions have not had damaging consequences for the target country's financial system.

Table 2  
**Recently targeted countries on the SDN list**

<b>Economy</b>	<b>Entities</b>	<b>Of which: Banks</b>	<b>Individuals</b>	<b>Aircraft</b>	<b>Vessels</b>	<b>Total</b>
Iran	939	140	394	195	205	1,733
Syria	171	29	457	38	10	676
Ukraine	178	56	230	3	8	419
North Korea	162	33	130	16	106	414
Russia	176	58	158	0	0	334
Venezuela	89	2	141	56	47	333
China	132	11	114	0	0	246
Cuba	73	4	5	0	4	82
Belarus	13	0	25	0	0	38
Hong Kong	0	0	8	0	0	8
<b>Total 10</b>	1,933	333	1,662	308	380	4,283

*Source:* OFAC Sanctions List Search, <https://sanctionssearch.ofac.treas.gov>. Data as of January 4, 2021. Data report designations based on OFAC program tags by country; China and Russia data cover country-specific and other OFAC programs.

Placement on the SDN list entails the freezing of the assets in US jurisdictions of the designated person or entity, US visa restrictions, and bans on dollar-based transactions. In many recent cases, however, entities or individuals listed have limited international exposure or had time to reallocate assets out of US reach before the sanctions were imposed. Some change their names or corporate structure to evade detection. For this reason, the SDN lists some people and entities that seem to be the same, often at the same address, multiple times. Keeping the list current and accurate requires substantial intelligence resources, including the use of classified means of information gathering.

Designating individuals and government entities with little international exposure to international markets or capable of rejigging ownership to evade sanctions has been a losing hand for US officials for many years. Naming and shaming hurts when the designee travels and has international relationships. When the target is ensconced in its home territory, and protected or subsidized by the ruling regime, the coercive impact of the economic sanction is significantly reduced.

### **CHINA IS NOT RUSSIA OR IRAN**

Postwar sanctions episodes have never targeted in a comprehensive way a large, diversified economy that is integrated into global supply chains and thus harder to isolate by economic sanctions. To date, the United States has imposed export and financial sanctions on several hundred Chinese firms and individuals (including a few high-level Communist Party officials responsible for policies in Xinjiang and the promulgation of Hong Kong's new national security law).



Many of the measures target the high-tech sector, particularly firms linked to the Chinese military and security forces.<sup>6</sup> The most prominent export controls limit shipments of US goods to firms such as Huawei, with the intent of blocking the transfer of advanced technologies that can have military applications.

Partial trade controls, like those imposed in the US-China trade war, have induced tit-for-tat retaliation and very little policy reform apart from what was already being pursued before the tariff war. Increased controls on US exports of high-tech goods and manufacturing equipment will certainly hurt Chinese growth in the short run. But there is no indication that Chinese policies have been moderated in response to US pressure. Instead, US sanctions have prompted China to provide subsidies to sustain and advance the targeted firms.

Moreover, as in the trade war, China has reciprocated in kind, imposing mirror-image restrictions against US interests. For example, China has threatened to blacklist US firms complying with US export controls targeting Chinese firms by placing them on an unreliable supplier list, the Chinese version of the Entity List maintained by the US Commerce Department to block or require special licenses for US exports to specific countries or firms. And when Chinese officials have been added to the SDN list, China has in turn named US officials, including US senators, whose travel and financial activities in China are similarly blocked, in a mocking illustration of the impotence and futility of the punitive measures.

The dangers of an escalating sanctions war with China have been lurking for several years, especially regarding Chinese commercial relations with Iran, North Korea, and Venezuela. China is one of the top oil customers of Iran and Venezuela, but Chinese energy trade with Iran and Venezuela was shielded from US sanctions by time-limited waivers until President Trump revoked such exemptions in May 2019.<sup>7</sup> US officials wisely and quietly avoided action against China's state-owned energy firms and the financial institutions that helped them execute transactions with Iran, in return for a ratcheting down of Chinese oil purchases over time from those countries.

Similarly, China has tempered its commercial ties with North Korea in response to US sanctions and UN mandates. But as in the case of Iran, Chinese officials ease up on the pressure when the sanctions threaten to suffocate the North Korean economy. Given the heightened pressure of US sanctions against Iranian banks announced on October 8, 2020, it would not be surprising if China joined other countries in opening new lines of economic relief for Iran through barter transactions that trade Iran's energy for needed humanitarian and other supplies, as done in the past. Doing so now could expose Chinese firms to US secondary sanctions, escalating the already fragile relations between the two countries.

The big risk in escalating sanctions against China is targeting systemically important financial entities. Currently, no global systemically important banks (G-SIBs) are on the SDN list. China is home to four of the world's five largest

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6 On November 12, 2020, President Trump [issued Executive Order 13959](#) barring US persons from transactions in publicly traded securities of Chinese military companies and their subsidiaries operating directly or indirectly in the United States. The actions cover companies listed on US stock exchanges such as China Mobile and China Telecom.

7 ZTE and Huawei were caught violating other US sanctions barring high-tech trade with Iran and subjected to massive fines and other specific penalties.

banks (by asset value). All of them have US operations. Putting any of them on the SDN list could cause widespread disruptions to trade and finance. China is likely to avoid retaliatory action using its massive dollar reserves, but it could further diversify its portfolio if the US-China conflict escalates.

Both sides need to tread carefully as US sanctions are deployed against Chinese policies in Xinjiang and Hong Kong, especially after the promulgation of Hong Kong's new national security law (NSL), imposed by the China's National People's Congress in late June 2020. US officials, however, must fit their sanctions policy to the requirements of Executive Order 13936, which mandates sanctions against those complicit in the formulation of the NSL as well the new Hong Kong Autonomy Act (HKAA), which prescribes an escalating series of mandatory measures over the next two years. Pursuant to Executive Order 13936, on August 7, 2020, Treasury added 11 individuals, including Hong Kong Chief Executive Carrie Lam, to the SDN list for their role in formulating the NSL.

The HKAA, signed into law on July 14, 2020, replicates some of the executive order and requires the US secretary of state to report on "foreign persons" that have "materially contributed to" the failure of the Chinese government to meet its obligations under the Joint Sino-British Declaration of 1984 or the Hong Kong Basic Law. On October 14, 2020, the State Department issued its first report under section 5(a) of the HKAA and listed 11 individuals (the same people already added to the SDN list in August by the Treasury). Within one year, these people face a freeze of their property subject to US jurisdiction and denial of US visas.<sup>8</sup>

Under section 5(b) of the HKAA, the Treasury secretary is required to issue a report that "identifies any foreign financial institution that knowingly conducts a significant transaction with a foreign person" cited in the State Department report. Section 7(b) of the statute sets out a menu of 10 types of restrictions that the president may impose on foreign financial institutions cited in the Treasury report. At least five of them must be imposed within a year of the report; the rest must be imposed within two years.<sup>9</sup>

Financial institutions doing business with people cited in the State Department report are thus liable to sanctions under the HKAA if US officials deem such transactions "significant." The standard is ambiguous, and so is the potential liability. This practice is standard operating procedure for US sanctions policy, forcing both US and foreign financial institutions to be extremely risk averse in dealings with individuals on the SDN list and their business partners lest they fall into noncompliance with US sanctions. Private firms (and, of course, US taxpayers) bear most of the enforcement costs of US sanctions policy. It is no longer enough to know your customer; OFAC requires that you know (or try hard to know) your customers' customers, an immense challenge when dealing with operations in China.

To date, HSBC and Standard Chartered have indicated they will comply with the NSL, so that they can continue operations in Hong Kong. But Article 29 of the NSL puts them in a bind, as it prohibits "collusion with a foreign country or external elements to endanger national security." Like US practice, the

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8 Hong Kong Autonomy Act (P.L. 116-149), section 6.

9 The sanctions bar loans or credits from US financial institutions, designation as a primary dealer, service as a repository for government funds, and foreign exchange transactions subject to US jurisdiction, among others.



definition of collusion is ambiguous, raising concerns that compliance with UN or US sanctions could put Hong Kong firms at risk of violating the new US law if they follow the new Hong Kong law and vice versa. In normal times, one would expect the financial institutions to work with the Treasury to establish sensible definitions and guidelines for how to avoid “significant transactions” with individuals or entities on the SDN list. But these are anything but normal times, especially for US-China relations.

The first Treasury Department report under section 5(b), issued December 11, 2020, did not identify “any FFI [foreign financial institution] that has knowingly conducted a significant transaction with a foreign person identified in the Section 5(a) Report.” But the monitoring continues, and Treasury will update its assessment, as necessary.

### RECALIBRATING SANCTIONS POLICY

US sanctions have punished targeted countries, reducing resources for and slowing the pace of weapons development and other aggressive actions. But they have also hurt millions of innocent people. The trade and financial controls have impeded humanitarian relief efforts, even though US law nominally exempts food and medicines from sanctions liability. US sanctions rarely provoke public uprisings against the ruling autocratic regime, even when conditions in the target economy become dire, as is now the case in Iran and Venezuela.

Recent history is replete with cases of good intention and bad or incomplete results. Too often, economic coercion had to be supplemented by military action, which sanctions were initially meant to avoid. Sanctions preceded but did not prevent the need for the use of military force in Panama, Libya, Iraq, and elsewhere. One would hope that big stick could be kept in the closet in managing disputes with Russia or China.

Financial sanctions seem the ultimate economic weapon, blocking commercial relations without military blockades. But the collateral costs are sizable, damaging US producers, financial institutions, and US alliances. The United States and Europe have been at odds over using sanctions against Iran and Russia; US relations with Europe and Japan may be tested if sanctions against China escalate.

Given the rising tensions with China over its policies in Xinjiang, Hong Kong, and the South China Sea and its ongoing support for Iran, North Korea, and Venezuela, US officials will be under pressure to ramp up financial sanctions against leading Chinese firms and financial institutions. They should proceed with caution. Too often, US officials have shot themselves in the foot by the ill-considered imposition of economic sanctions. The US Treasury should avoid designating G-SIBs and other high-profile entities without a full analysis and clear understanding of the potential consequences for US interests and international financial markets.

A better approach is to follow a more moderated course, deploying both carrots and sticks calibrated to the specific case. Not surprisingly, this strategy helped secure the last successful sanctions episode, in 2015, when sanctions got Iran to join negotiations and ultimately accept concrete constraints on its development of nuclear weapons in return for normalization of commercial relations with most countries except the United States (which maintained almost

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all its primary sanctions against Iran). Critical to this outcome was the fact that US and EU policies were closely coordinated. After four years of conflict with our own allies, there is an even greater need to cooperate, and at times compromise, with key partners to ensure effective implementation of sanctions policies.

US officials should remember that sanctions are only one of many options in the toolkit of economic statecraft. Instead of ramping up financial sanctions and risking fractures in financial markets, US officials should pursue other strategic economic countermeasures against abusive foreign practices. Some have already been vetted in response to Chinese policies in Xinjiang (banning imports from the region made with forced labor) and Hong Kong (extending visas to Hong Kong residents). Other measures—including subsidizing research and development of advanced microelectronics and increasing the production and stockpiling of strategic minerals—could draw on historic precedents. Even if the US measures do not induce fundamental changes in Chinese policies—which seems likely given the intractable political commitment of Xi Jinping to their continuing implementation—sanctions demonstrate US disapproval and make the execution of Chinese policies more costly and less effective.

Chinese policies pose major challenges for the United States and its allies. In specific instances, sanctions are an appropriate response, especially if coordinated with and implemented in tandem with US allies. But high-voltage financial sanctions should be avoided except in extremis.

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