

‘Coercive Cooperation’ in Action: Explaining South Korea’s Non-proliferation Financing Regime*

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Inducing cooperation from hesitant members in a sanctioning coalition is critical for effective implementation of a financial sanction. Strategic cooperation among states with divergent interests involves time inconsistency and incomplete information, however. A ‘coercive cooperation’ approach addresses this problem either by imposing ex post costs through higher audience costs or offering ex ante benefits through tactical issue linkage. This paper applies a Bayesian equilibrium model to address the sequencing of these two main factors that contribute to ‘coercive cooperation’. Unlike in games with complete information, our model explains why the sender state not only resorts to international institutions but also employs unilateral countersanctions to enforce compliance in a sanctioning coalition. It is shown that international organizations offer ex ante benefits through issue-linkage while the sender state imposes ex post costs with a threat of countersanctions. When the follower state perceives the benefits to be greater than the costs, it has strong incentives to join the coalition with no substantive change in implementing measures. Once in a bandwagon, however, the sender can bring about active implementation by imposing audience costs on himself and the follower. The predictions from the model have been supported by the case study on South Korea’s non-proliferation financing regime.

Keywords: WMD Financial Sanctions, Coercive Cooperation, Bayesian Equilibrium

1. INTRODUCTION

The effectiveness of economic sanctions, including the so-called targeted sanctions, has been the enduring topic of scholarly debate on the subject (Rogers, 1996; Pape, 1997; Baldwin, 1999; Elliott, 2002; Drezner, 2015). The extant literature highlights specific conditions for a successful sanction such as the substantial damage on the target (Drezner, 1997), the dispute’s low salience (Morgan and Schwebach, 1997), the democratic nature of the target state and anticipation of no future conflicts (Allen, 2005; Drezner, 2000), the involvement of international institutions (Bapat and Morgan, 2009), the market share of the sender’s firms in the target (Bapat and Kwon, 2015), and shows a higher success rate at the threat stage than at the imposition stage (Nooruddin, 2002). These findings cast doubts on the existing sanction’s effectiveness on ‘big cases’ like Iran and North Korea since they point out “the key to making sanctions work is to threaten allied democracies on small matters of import” (Drezner, 2011: 99). Further, on the important topic of the target’s damage, Iraq’s humanitarian crisis following one of the most comprehensive UN sanction in the 1990s led many policymakers and scholars to look into who are most affected by sanctions inside the target state (Kaempfer, Lowenberg and Mertens, 2004). More often than not, suffering

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was inflicted on the vulnerable and the powerless, especially on women with the minimum impact on the core regime supporters (Buck, Gallant and Nossal, 1998). This recognition led to the targeted ‘smart sanction’ – financial sanctions, travel bans, restrictions on luxury goods, and arms embargoes. Financial sanctions “consist of asset freezes, limited or total bans from the international financial system, and sanctions on banks that facilitate terrorist or proliferation-related transactions” and aim to “cut the financial lifeline supporting the targeted group or regime and their illicit activities” (Ouagrham-Gormley, 2012: 243). Despite the ongoing controversies over the conditions for a successful sanction, Baldwin (1999: 81) argues for distinguishing whether sanctions *work* from whether they should be *used* in light of the relative cost and benefit of a particular sanction compared with other options of influence. Granted that this distinction is valid and important, the relative merit of financial sanctions vis-a-vis trade sanctions or other variants of targeted sanctions has been amply noted by researchers and practitioners alike (Dashti-Gibson, Davis and Radcliff, 1997; Hufbauer, Schott and Elliott, 2007; Passas, 2011; Zarate, 2013). According to its supporters, financial sanctions differ from others in that they are targeted with limited collateral damage while imposing significant costs on target economies (Ekert, 2008; Loeffler, 2009; Zarate, 2013). Due to the U.S. pre-eminence in global financial markets and the U.S. dollar’s role in international transactions, there is less incentive to “defect from the sanctions regime” (Drezner, 2015: 758).

However, as financial sanction has gained momentum in economic statecraft, more recent scholarship has noted its shortcomings in galvanizing support from the banking sector and other national governments in the implementation phase, especially with respect to financial sanctions against WMD proliferation (Ouagrham-Gourmley, 2012; Ganguli and Ernoult, 2012; Arnold, 2016). Ouagrham-Gourmley (2012), based on interviews with bank and government representatives, argues that a traditional focus on the impact of sanctions on the receiving end neglected the shortcomings in implementation and calls for a greater role of government agencies in different jurisdictions in training and information support for the banking sector. Ganguli and Ernoult (2012), after surveying a EU regime to combat WMD financing, concludes that financial measures can play only a limited role next to national export control measures due to the lack of actionable information by competent authorities. They further point out inadequate coordination between international agencies and national regulators, resulting in “highly complex, opaque and, to some extent, contradictory layers of regulations... making it extremely difficult for banks to effectively implement these measures” (Ganguli and Ernoult, 2012: 2). On the specifics of counter-proliferation financing, Arnold (2016: 89) notes that “most of the red-flag indicators for money laundering are not relevant to proliferation. Whereas money laundering usually involves hiding the source of illicit proceeds, proliferation financing is concerned with hiding the end-user.” The ongoing debates on the implementation of financial sanctions call for more integrated, harmonized approach between regulators in supplying actionable information and engaging the banking sector. Without such efforts, the implementation difficulties would certainly add to the passivity of a hesitant follower in the sanctioning coalition.

Fundamentally, policy coordination between states with divergent interests involves asymmetric strategic problems – time inconsistency and incomplete information (Fearon, 1997; Powell, 1999). A follower member in the sanctioning coalition would worry about time inconsistency if the dominant sender nation later changes its course, thereby losing its current commercial interests in a target nation (Sechser, 2010). On the other hand, a dominant sender nation suffers from incomplete information problem since a follower nation could have a

strong incentive to free ride by hiding its commercial relations with a target nation (Shultz, 2001). To meet these challenges, a dominant sender makes commitments by imposing *ex post* costs on itself and others in the case of future obstructions while offering a follower with *ex ante* benefits to facilitate information exchange (Kim, 2014). These standard remedies are two main components of 'coercive cooperation' – self-imposed audience costs and tactical issue linkage – the concepts to which we will turn shortly. In the followings, we first briefly describe the concept of 'coercive cooperation' and its main components. Second, we develop a sequential model of 'coercive cooperation' based on multi-stage Bayesian equilibrium under incomplete information. Lastly, we analyze the case of South Korea as a hesitant member in the sanctioning coalitions against Iran accordingly.

2. A 'COERCIVE COOPERATION' APPROACH

2.1. The Concept

Since Martin (1992), the concept of 'coercive cooperation', obtaining cooperation within a sanctioning coalition through coercion, has earned its place in the economic sanctions literature (Mansfield, 1994; Kaempfer and Lowenberg, 1999; Drezner, 2000; Urpelainen, 2010). Martin's main contribution comes from identifying the two key factors – tactical issue linkage through institutions and self-imposed audience costs – that augment the 'credibility of commitments' or 'reputation' of a leading sender nation, thereby making the other members bandwagon (Lake, 1995: 349). A large body of empirical works on reputation and the role of these two factors in international disputes followed (Dorussen and Mo, 2001; Poast, 2012; Lacy and Niou, 2004; Butler, 2007; Sechser, 2010; Downs and Jones, 2011; Kurizaki and Whang, 2015). For example, Poast (2012: 277) confirms issue linkage's ability to help clinch an agreement in alliance negotiations using matching techniques. Kurizaki and Whang (2015) offers empirical evidence for the existence and effectiveness of Fearon's 'audience costs' in international disputes such as economic sanctions. However, the level of cooperation and the level of success of a sanction seem to be two different matters. Against conventional wisdom, there has been a wide range of empirical works showing the relative effectiveness of unilateral sanctions over multilateral ones (Hufbauer, Schott and Elliott, 1990; van Bergeijk, 1994; Bonetti, 1997; Miers and Morgan, 2002). Drezner (2000: 74) traces this vexing problem to implementation difficulties from endemic free-riding among the sanctioning nations rather than bargaining problems between the primary sender and the target or among the sanctioning nations. Drezner (2000: 99) finds 'an independent and significant' role of international organization in reducing a free-rider problem. Moreover, from spatial models of voting, another important study on multilateral sanctions shows that multilateral sanctions often become "less effective than unilateral sanctions because the nature of coalitional bargaining renders it impossible to maintain consistency in the demands made of the target when there are more than one issue involved in a sanction" (Bapat and Morgan, 2009: 1080). Instead of simple free-ridership in any multilateral sanctions, bargaining within a sanctioning coalition over the most preferred position of all members warrants a key role played by international institution in providing consistency to the coalition's demands (Bapat and Morgan, 2009). The authors conclude "multilateral sanctions can be more effective than unilateral sanctions if multilateral sanctions are either unidimensional, or multidimensional and conducted through an international institution" (Bapat and Morgan, 2009: 1080).

Should the involvement of international institutions be critical to a successful multilateral sanction, how do international institutions address two inherent problems in strategic cooperation between the sender state and the follower state with power asymmetry, namely 'time inconsistency' and 'incomplete information'? 'Time inconsistency' looms larger for the relatively weaker follower in a sanctioning coalition because she will be more vulnerable if the sender later reneges on the terms of a sanction, thereby making the follower restore her commercial dealings with the target later. Weaker nations are suspicious of this unequal vulnerability and unwilling to join the coalition (Krasner, 1985; Williams, 1993; Shadeln, 2008). One way to entice their participation is to raise the sender's *ex post* cost of renegeing. As Fearon (1997) explains, the sender could introduce 'tying-hand' measures that would force him to incur 'audience costs' if he did not live up to his promises or threats. The role of international institutions with respect to 'audience costs' is straight-forward in Martin (1993). She assumes in her 'countersanctions game' that a sanction through an international institution is itself a 'high-cost' strategy because of the cost involved in gaining support of the institution's members, thus resulting in higher 'audience cost' if the sender does not retaliate the follower in the case of noncompliance. She then finds an equilibrium where the sender imposes a high cost sanctions through an international institution and the follower complies when the cost of retaliation for the sender is smaller than the audience cost of no retaliation (Martin, 1993: 420). This configuration, however, leaves out the problem of 'incomplete information' in coalition bargaining. 'Incomplete information' is more of a problem for the sender than the follower when a sanction often requires domestic regulatory changes that conform to the sender's standards such as export controls or reporting requirements in financial transactions. On financial regulations such as non-proliferation financing, Simmons (2001: 607) notes, "for a number of reasons, smaller jurisdictions tend not to want to emulate the tighter regulations of the dominant centres. Indeed, stringent reporting requirements in the U.S. may make the banking secrecy offered by the legitimate private banking industry even more lucrative... Because most countries do not wish to emulate U.S. policies, and because the externalities to the U.S. have been high, the harmonization that has taken place has been driven by hardball political pressure." Thus, the follower has strong incentives to free ride by not actively implementing the sanctioning measures. International institutions not only provide information, set standards, encourage repeated interaction, but facilitate the provision of *ex ante* benefits from the follower's cooperation though the forging of issue linkages (Keohane, 1984; Martin, 1993). From this perspective, a core function of international institutions is to reduce 'incomplete information' in strategic cooperation. As Bapat and Morgan (2009) convincingly shows, sanctions by nature involve more than one issue and preference ordering through issue-linkage among coalition members is the essential function of international institutions raising the success rate of multilateral sanctions.

Above findings suggest that international institutions provide both *ex post* costs and *ex ante* benefits by increasing audience costs and facilitating issue-linkages. They fall short, however, of adequately explaining the evolution of financial sanctions regime against WMD proliferation. Financial sanctions against WMD proliferation is the issue area where self-imposed costs through the use of 'secondary sanctions' have become a norm and international institutions provide multiple venues for tactical issue linkages. For example, in almost all of financial sanctions against Iran, the U.S. government has been using 'secondary sanctions' to increase the level of cooperation and effectiveness. From a 'coercive cooperation' perspective, the passage of domestic legislations such as *Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010* (CISADA) with mandatory 'secondary

sanctions’ clauses imposes *ex post* costs at home and abroad, adding to credibility of a leading sender nation. At the same time, financial sanctions against WMD proliferation take place in the intersection of international organizations as a supplier of standards and the national governments (and the market, of course) as an enforcer. Thus, the field is home to actors and venues ranging from the United Nations (UN) to the Financial Action Task Force (FATF) to the national governments. This hybrid nature of financial sanctions calls for better understanding on how the task of increasing *ex post* costs and *ex ante* benefits are divided among various actors. International institutions are notorious for its lack of enforcement powers. As Urpelainen (2010: 646) notes, “if states are to enforce international cooperation, they need to secure sufficient enforcement power while preventing abuses of power. If powerful states cannot commit to such constraints, weak states have every reason to anticipate minimal gains from cooperation, so they refuse to negotiate. Powerful states should deliberately reduce the supply of collective enforcement power even if this results in shallow cooperation.” Naturally, there needs to be more work to shed light on how to more effectively combine the key factors of multilateral cooperation to enhance implementation within a sanctioning coalition, specifying Martin’s finding of a “strong positive relationship between the costs of sanctions or the use of institutions and the level of cooperation observed” (Martin, 1993: 431). We inquire how increasing ‘audience costs’ can be *sequentially* combined with ‘issue linkage’ to maximize its impact on coalition members’ compliance in WMD financial sanctions with a model of multi-stage Bayesian equilibrium under incomplete information. As Martin acknowledged, her models are one-shot games of complete information and highly artificial (Martin, 1992: 37).

2.2. A Sequential Model of ‘Coercive Cooperation’

Repeated enforcement game

Table 1 illustrates a simple 2 x 2 enforcement game, to be called a ‘normal type’ game, between the Sender (*S*) and the Follower (*F*). For the sake of simplicity, the status quo payoff is given as (*S*: enforce, *F*: comply) = (0, 0). Under this set-up, a noncompliant *F* reaps the benefit by saving the cost of compliance *c*. *S* can also save the enforcement cost *d* by not enforcing. A noncompliant *F* incurs damage *b* to *S* and when enforced, will face the penalty *a*. To begin, model parameters are assumed to rank as follows: penalty (*a*) of noncompliance on *F* should be bigger than the damage (*b*) incurred on *S* by *F*’s noncompliance; *S*’s cost of enforcement (*d*) should be smaller than the damage (*b*) incurred by *F*’s noncompliance. Under this setup, when the size of *F*’s compliance cost (*c*) is bigger than the penalty of noncompliance (*a*), there is a pure strategy Nash equilibrium at (*Enforce*, *Not Comply*).

When $a > c$, however, there is no pure strategy equilibrium. Instead, one has to consider a mixed strategy equilibrium. *S* and *F* will choose to enforce and comply with the probabilities *p* and *q* that guarantee the same expected payoff for the strategies that they have available. A mixed strategy Nash Equilibrium leads to the probability of compliance $q = (b-d)/b$, and the probability of enforcement $p = c/a$. The equilibrium Nash payoff for this one-shot game is (0, 0) for (*S*, *F*). Extending our analysis from one-stage to multi-stage games does not change the outcome. Figure 1 describes a multi-stage enforcement game in stepwise sequence. We assume that the game ends at the first stage when both players reach the nodes of ①, ③, and ④. It stands to reason that the option of initial compliance irrespective of the outside enforcement at ① and ③ involves little incentive to weigh the value of future compliance against that of future noncompliance when sizable adjustment costs *c* in domestic

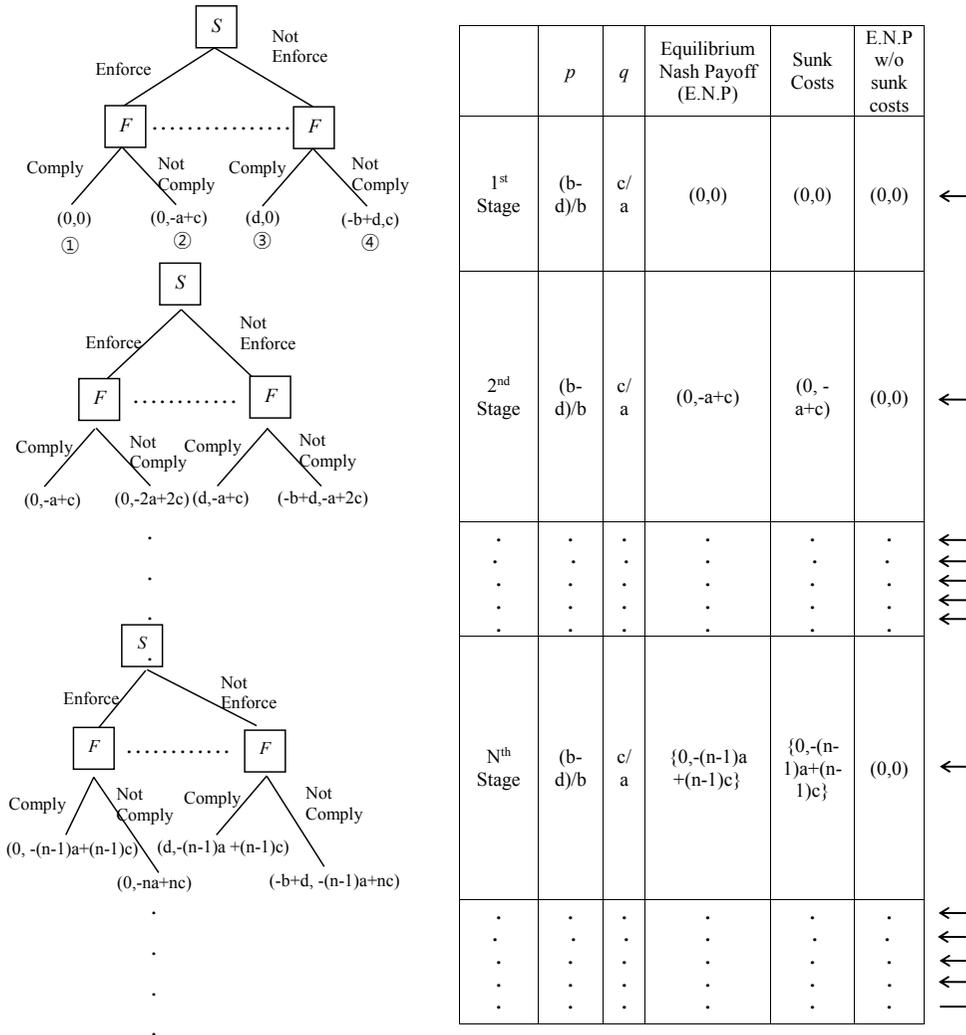
Table 1. ‘Normal Type’ Enforcement Game

		Follower (F)	
		Comply (q)	Not Comply ($1-q$)
Sender (S)	Enforce (p)	(0, 0)	(0, -a+c)
	Not Enforce ($1-p$)	(d, 0)	(-b+d, c)
Model Parameters		Interpretations	
a		Penalty of noncompliance on F	
b		Damage to S of F 's noncompliance	
c		F 's compliance cost	
d		S 's cost of enforcement	
p		Probability of enforcement	
q		Probability of compliance	

financial regulations have been paid already. Also, the option of initial noncompliance when faced with no enforcement at ④ is the best outcome from F 's perspective. A trouble for F 's decision-makers lies at ② where noncompliance is detected and enforced by S . F , having paid the penalty of noncompliance a at ②, has to weigh the value of future compliance with adjustment costs c against that of continued noncompliance.

In a game of infinite iterations, F has to incorporate the subsequent equilibrium Nash payoffs. That is, the value of n^{th} stage equilibrium Nash payoff has to be rolled back to the previous $(n-1)^{\text{th}}$ stage with the discount factor δ , to give us the equilibrium Nash payoff at the $(n-1)^{\text{th}}$ stage. This process of rolling-back has to continue until we reach back to ② at the first stage. Rolling back the discounted Nash payoff excluding sunk costs, $\delta(0, 0)$, leaves our first stage payoff structure unchanged. Given the unchanging payoff structure with infinite iterations of the game, we now revisit the first stage normal type enforcement game reflecting two payoff changes – introduction of institutional ‘issue-linkage’ and ‘audience costs’ (Table 2). A reward in the form of institutional ‘issue-linkage’ provides F with the benefit x when F complies with the requirements of membership in an existing international institution, without additional costs on S as far as F voluntarily joins the international institution for the benefits of membership. In fact, most of international standards on non-proliferation financing was developed and spread from the Financial Action Task Force (FATF), a typical club organization with stringent membership and accession criteria. Once created, the benefits of joining an exclusive club “sufficiently alter market payoffs to non-members such that they *want to join*, even if they were better off under the status quo prior to the creating of a club” (Drezner, 2007: 75). When $c < x$, we have a pure strategy equilibrium at (*Not Enforce, Comply*) = (d, x). When $c > x$, a mixed strategy equilibrium with infinite iterations is shown in the second panel of Table 2. ‘Audience costs’ in financial sanctions against WMD can be captured in the threat of unilateral countersanctions such as mandatory ‘secondary sanctions’, and shown as y_A and y_B for nation S and F in the third panel of Table 2. When enforced, a ‘secondary sanction’ will cost a noncompliant F the ‘audience cost’ of y_B . When not enforced, it will cost S the ‘audience cost’ of y_A . The new payoff structure with ‘audience costs’ (a ‘threat’ hereafter) is shown in the third panel of Table 2. With infinite iterations, the equilibrium Nash payoffs, excluding sunk costs, stay the same for each successive stage: ($0, x$) for a ‘issue-linkage’; ($0, 0$) for a ‘threat’; ($0, x$) for a ‘issue linkage and threat’ game. Rolling

Figure 1. Mixed Strategy Nash Equilibrium for Infinite Enforcement Game



back the discounted second stage Nash payoff of $(0, \delta x)$ to the *(Enforce, Not Comply)* cell for a ‘issue-linkage’ game, mixed strategy equilibrium values are $p = (c-x)/(a-\delta x)$ and $q = (b-d)/d$. For a ‘threat’ game, $p = c/(a+y_B)$ and $q = (b-d+y_A)/(b+y_A)$. For a ‘issue-linkage and threat’ game, the equilibrium values are $p = (c-x)/(a+y_B-\delta x)$, $q = (b-d+y_A)/(b+y_A)$. Then, in a game of infinite iterations with perfect information, compliance rate (q) will be higher with ‘audience cost’ (y_A), whereas q remains unchanged with ‘issue-linkage’ only.

Bayesian equilibrium

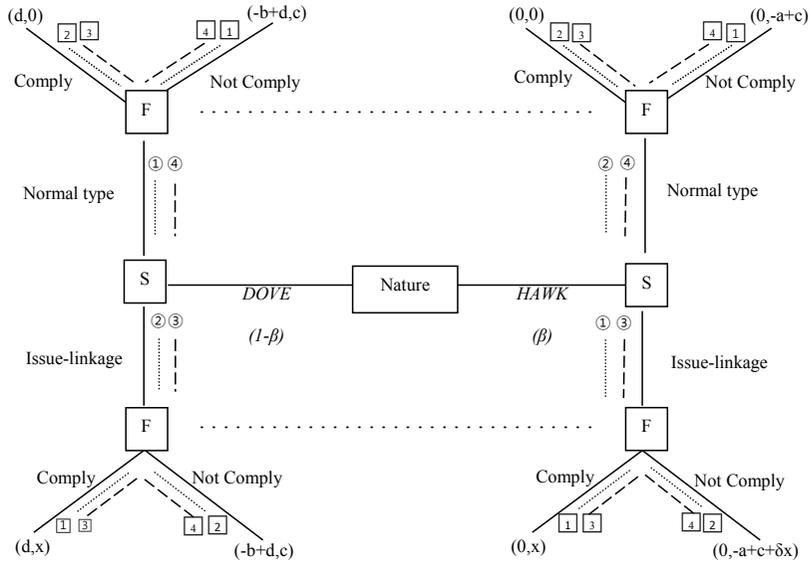
Figure 2 rearranges the rolled-back payoffs from Table 2 into a dynamic incomplete game. Figure 2 shows that nation F does not know whether enforcement would take place, but she knows whether the game being played is a ‘normal type’ or a ‘issue-linkage’ game. These are the signals against which F adjusts her information on S ’s type - a hawk (β) with

Table 2. Enforcement Games with Perfect Information under Different Specifications

‘Normal Type’ Game after rolling back future payoffs		F	
		Comply (q)	Not Comply ($1-q$)
S	Enforce (p)	(0, 0)	(0+0, -a+c+0)
	Not Enforce ($1-p$)	(d, 0)	(-b+d, c)
Mixed strategy Nash Equilibrium after rolling back : $p= c/a, q=(b-d)/b$ Equilibrium Nash payoff in every repetition excluding sunk costs : (0,0)			
With institutional ‘issue-linkage’ after rolling back future payoffs		F	
		Comply (q)	Not Comply ($1-q$)
S	Enforce (p)	(0, x)	(0+0, -a+c+ δx)
	Not Enforce ($1-p$)	(d, x)	(-b+d, c)
Equilibrium after rolling back : $p= (c-x)/(a-\delta x), q=(b-d)/b$ Nash payoff in every repetition excluding sunk costs: (0, x)			
With a threat of countersanctions after rolling back future payoffs		F	
		Comply (q)	Not Comply ($1-q$)
S	Enforce (p)	(0,0)	(0+0, -a+c- y_B +0)
	Not Enforce ($1-p$)	(d,0)	(-b+d- y_A, c)
Equilibrium after rolling back: $p=c/(a+y_B), q=(b-d+y_A)/(b+y_A)$ Nash payoff in every repetition excluding sunk costs : (0,0)			
With ‘issue-linkage’ and ‘threat’ after rolling back future payoffs		F	
		Comply (q)	Not Comply ($1-q$)
S	Enforce (p)	(0, x)	(0+0, -a+c- y_B + δx)
	Not Enforce ($1-p$)	(d, x)	(-b+d- y_A, c)
Mixed strategy Nash Equilibrium after rolling back : $p= (c-x)/(a+y_B-\delta x), q=(b-d+y_A)/(b+y_A)$ Nash payoff in every repetition excluding sunk costs : (0, x)			

certain enforcement or a dove ($1 - \beta$) with no enforcement. There are four pure strategies for each player in this game, producing sixteen possible combinations of pure strategies: ① A hawk presents a ‘issue-linkage’ and a dove ‘normal type’ game; ② A hawk presents a ‘normal type’ and a dove ‘issue-linkage’ game; ③ S presents a ‘issue-linkage’ game regardless of its type; ④ S presents a ‘normal type’ game regardless of its type; ① F complies in a ‘issue-linkage’ but not in a ‘normal type’ game; ② F complies in a ‘normal type’ but not in a ‘issue-linkage’ game; ③ F complies no matter what; ④ F does not comply no matter what. Out of the sixteen possibilities a perfect Bayesian equilibrium is the combination of strategies no player is willing to deviate from. Both players’ strategies can be grouped into either ‘separating strategies’ (①, ②; ①, ②), or ‘polling strategies’ (③, ④; ③, ④). In Figure 2, there is no

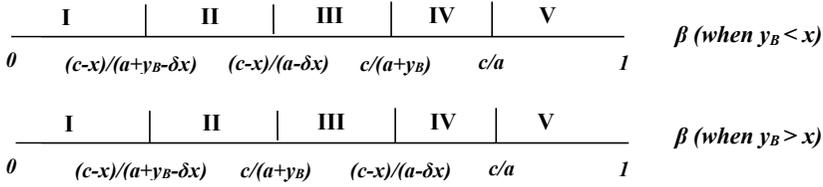
Figure 2. A Dynamic Incomplete Game with ‘Normal Type’ vs. ‘Issue-Linkage’



perfect Bayesian equilibrium from the combinations of ‘separating strategies’. When S pursues the strategy ①, it is rational for F to pursue ① since $x > (-a+c+\delta x)$ and $c > 0$. When S pursues the strategy ②, it is rational for F pursue ② since $0 > (-a+c)$ and $c > x$.

Can this be a perfect Bayesian equilibrium? No, because in the ①-① combination, a dove has every incentive to switch to ‘issue-linkage’ since doing so would increase its payoff from $(-b+d)$ to (d) . Also in the case of ②-②, a dove can switch to a ‘normal type’ game and benefit by b . It is not rational to respond with pooling strategies of ③ or ④ when S is using separating strategies. For example, responding with ③ to ① is not rational since it is better to switch to noncompliance when a dove presents a ‘normal type’ game, increasing the payoff from 0 to c . What about ‘pooling strategies’? Since F cannot use any information about the type of S from the signal, it should naturally mix its strategy. Given ③, F would comply if the expected payoff from compliance, $x(1-\beta)+x\beta$, is larger than that from noncompliance, $c(1-\beta)+(-a+c+\delta x)\beta$. Thus, comply when $\beta > (c-x)/(a-\delta x)$, and not comply otherwise. When the condition $\beta > (c-x)/(a-\delta x)$ holds, it is rational for F to pursue ③ because by definition there is no possibility of a ‘normal type’ game taking place. In this case, neither a hawk nor a dove has an incentive to change its strategy. The combination of ③-③ is a Bayesian equilibrium. When the condition $\beta < (c-x)/(a-\delta x)$ holds, F will respond with ④ and again there is no incentive for either party to move from this Bayesian equilibrium of ③-④ combination. Given ④, F would comply when $\beta > c/a$ and not comply otherwise. By the same logic, the combination of ④-③ is a Bayesian equilibrium when $\beta > c/a$ while the combination of ④-④ is another equilibrium when $\beta < c/a$. Following the same routine for a ‘threat’ game as well as a ‘issue-linkage and threat’ game, we have eight Bayesian equilibrium combinations: S presents a ‘normal type’ game regardless of its type and F complies if $\beta > c/a$, not if $\beta < c/a$; S presents a ‘threat’ game regardless of its type and F complies if $\beta > c/(a+y_B)$, but not if $\beta < c/(a+y_B)$; S presents an ‘issue-linkage’ game regardless of its type and F complies if $\beta > (c-x)/(a-\delta x)$, not if $\beta < (c-x)/(a-\delta x)$; S presents an ‘issue-linkage and threat’ game regardless of its

Figure 3. The Range of Bayesian Equilibrium along Player F 's Perception of S



type and F complies if $\beta > (c-x)/(a+y_B-\delta x)$, but not if $\beta < (c-x)/(a+y_B-\delta x)$.

Figure 3 shows the overlapping ranges of compliance and non-compliance along the F 's perception of S . When y_B has uniform distribution between 0 and x ($0 < y_B < x$) and c between x and a ($x < c < a$), then $c/(a+y_B) > (c-x)/(a-\delta x)$ or $y_B < (a-c\delta)x/(c-x)$ in Figure 3. This is because the probability of $y_B < (a-c\delta)x/(c-x)$ equals $(a-c\delta)/(c-x)$. With δ converging to 1 , the probability becomes $(a-c)/(c-x)$ whose expected value equals 1 since $E(c) = (a+x)/2$. Under this condition, all of the following inequalities hold: F will never comply under any circumstances within range I. Within range II, F will comply only when presented with 'issue-linkage and threat'. In range III, F will comply when presented with either an 'issue-linkage' or 'issue-linkage and threat' game, but not comply otherwise. In range IV, F will comply unless it is presented with a 'normal type' game. In range V, F will comply all the time. In other words, when the perceived cost from a threat of additional sanctions from S is smaller than the perceived benefit from 'issue-linkage' ($0 < y_B < x < c < a$), adding 'issue-linkage' is more powerful than adding a 'threat' on the existing structure of a 'normal type' enforcement game, with a 'issue-linkage and threat' combo maximizing the Bayesian compliance zone. Thus, 'issue-linkage and threat' > 'issue-linkage' > 'threat' > 'normal type' game in the order of effectiveness. Likewise, when $y_B > x$, adding a 'threat' on the existing structure of a 'normal type' enforcement game is more powerful than adding institutional 'issue-linkage.'¹ Thus, 'issue-linkage and threat' > 'threat' > 'issue-linkage' > 'normal type' game in the order of effectiveness. Together, the range of Bayesian equilibrium along β – nation F 's perception of S 's type – clearly illustrates that unless the 'audience costs' in the form of an additional 'threat' is perceived to be larger than the benefits from 'issue-linkage', an 'issue-linkage' game has better chance of inducing compliance with incomplete information. Furthermore, there is always an incentive to couple 'issue-linkage' with a 'threat' since the combination will produce the largest zone of compliance. These results stand in sharp contrast to the mixed strategy equilibrium with complete information. A higher audience cost in the form of an additional threat raises the equilibrium value of compliance q from $(b-d)/b$ to $(b-d+y_A)/(b+y_A)$ whereas 'issue-linkage' benefits decrease the equilibrium value of enforcement rate p from c/a to $(c-x)/(a-\delta x)$ with no change in compliance rate q (Table 2). With incomplete information, however, the relative size of F 's 'audience costs' (y_B) and 'issue-linkage' benefits (x) matters and should differ in different cases. It is up to the case-based evidence to which I turn.

¹ When y_B is bigger than x and has uniform distribution between x and a ($x < y_B < a$), then $c/(a+y_B) < (c-x)/(a-\delta x)$ or $y_B > (a-c\delta)x/(c-x)$. This is because the probability of $y_B > (a-c\delta)x/(c-x)$ equals $(ac-2ax+c\delta x)/(a-x)(c-x)$. With δ converging to 1 , the probability becomes $(ac-2ax+cx)/(a-x)(c-x)$ whose expected value equals 1 since $E(c) = (a+x)/2$.

3. EXPLAINING THE SOUTH KOREAN RESPONSE

3.1. International Backdrop

Figure 4 illustrates different actors and venues for standard-setting and enforcement in global financial sanctions regime against WMD proliferation, ranging from the United Nations (UN) to the Financial Action Task Force (FATF) to the U.S. government.

The UN Security Council Resolution (UNSCR) derives their coercive power upon member states from its Charter.² In April 2004, shortly after Dr. Abdul Khan who was in charge of the Pakistan’s nuclear program was caught for running a clandestine smuggling ring for nuclear materials, the Security Council passed the resolution 1540 establishing for the first time binding obligations on all member states to take and enforce effective measures against the proliferation of WMD. Among the measures banning proliferation of sensitive items to non-State actor, regulations specific to ‘the provision of funds and services that contribute to proliferation’ were introduced. It has since then become the obligations of the member states to prohibit financing of such proliferation in their domestic legal system. Subsequently, the Security Council established the 1540 Committee to monitor the national implementation of the resolution through national reporting requirements and expert assistance.³ The FATF is an intergovernmental organization set up by G-7 in 1989

Figure 4. Regulations against WMD Proliferation Financing

Locus of Standards	Form of Regulations	Mode of Enforcement	Area of Criticism
United Nations (UN)	UN Security Council Resolutions	Mandatory	Legitimacy
Financial Action Task Force (FATF)	Recommendations and Guidelines	Voluntary	Accountability
United States (US)	Domestic Acts and Executive Orders	Threats and Persuasion	Extraterritoriality

² By joining the UN, member states agree to abide by the decisions made by the Security Council and make available ‘armed forces, assistance, and facilities’ on matters of international peace and security. According to the Article 48 in Chapter 7 of the UN Charter, “(T)he action required to carry out the decisions of the Security Council for the maintenance of international peace and security shall be taken by all the Members of the United Nations or by some of them, as the Security Council may determine.”

³ For example, the government of South Korea (Oct. 2004, Sep. 2005) has twice reported to the 1540 Committee their implementation reports produced up to that point. These reports are available at www.un.org/sc/1540/nationalreports.shtml

to develop and promote policy measures countering the use of the financial system by criminals. Beginning with 16 members, it has expanded its membership to 37 countries including South Korea. In the areas of money laundering and terrorist financing, the FATF has produced 40 recommendations so far. With respect to ‘proliferation financing’, it named the issue as emerging threats and has produced guidance to address the Iranian problem in its 2007 plenary meeting. In 2008, it published typologies and guidelines to counter these threats within the framework of the UNSCR 1540. More recently, the FATF issued in February 2013 “new mechanism to strengthen WMD and terrorist financing compliance in member countries” (FATF, 2013). To spread and enforce its standards, the FATF adopts three strategies: mutual evaluations among members; institutional partnership with other IGOs; ‘naming and shaming’ non-cooperative jurisdictions. It conducts on-site assessments on member states’ degree of implementation on its recommendations. Upon a review by all members, it can impose sanctions ranging from one of a lesser degree such as a warning letter to one at the highest level such as expulsion from the organization. It partners with the IMF and the World Bank through their surveillance programs such as the Financial Sector Assessment Program (FSAP) and its key component, the Reports on the Observance of Standards and Codes (ROSCs).⁴ Also notable for regulating non-members is the designation and publication of “non-cooperative countries and jurisdictions” (NCCTs). Upon designation, the FATF could require its members to “condition, restrict, target, or even prohibit financial transactions” with NCCTs (FATF, 2013). With the threats of sanctions, 73 percent of the fifteen target countries so far have made their concessions prior to the implementation of any sanctions (Drezner, 2007). The last and the most contentious mode of enforcement comes from the U.S. It has exerted its superpower status to persuade or threaten other jurisdictions into punishing certain individuals and entities of proliferation concerns, based on U.S. domestic laws and regulations. For instance, the White House issued the Executive Order 13382 in June 2005. It imposed extraterritorial jurisdiction on foreign banks, companies, and individuals “who provided, or attempted to provide, financial, material, technological or other support for, or goods or services in support of, any activities or transactions that have materially contributed to, or pose a risk of materially contributing to, the proliferation of weapons of mass destruction or their means of delivery” (Federal Register, 2005). Moreover, Title III of the Patriot Act, enacted immediately after the September 11th attacks, imposed “sweeping extraterritorial measures that create additional requirements for record keeping, specific transaction reporting, and disclosure obligations that apply to foreign banks and companies that do business in the U.S. or which maintain private banking or correspondent accounts with the U.S. financial institutions” (Alexander, 2002). The available sanctions on third party persons or entities are comprehensive, ranging from severing trade ties to freezing assets within U.S. control. In the cases of Iran and North Korea, the U.S. authorities have designated 184 entities and individuals based upon this Order, 42 (23%) of which are from third parties excluding explicit foreign subsidiaries of Iranian and North Korean origin (OFAC, 2010).

⁴ Since 2004, FATF recommendations have been included in the twelve ROSC standards. This linkage provided the FATF with wider reach and bigger capacity for technical assistance in non-member countries (IMF, 2013).

3.2. Domestic Implementation

The South Korean regulatory system against proliferation financing came into effect in December 2008, one year after the enactment of the much anticipated *Prohibition of Financing for Offences of Public Intimidation Act* (PFOPIA).⁵ The Act for the first time criminalized funding terrorist or nuclear-program related activities. Although it still falls short of including those funds or assets not directly linked to terrorist or nuclear activities, its passage was crucial in landing South Korea a membership at FATF in 2009 (FATF, 2009). Prior to PFOPIA, basic reporting requirements and intelligence functions were put in place in response to the UNSCR 1373. Immediately after the 9.11 attacks in 2001, the UNSCR 1373 mandated members to criminalize, freeze, and prohibit terrorist related funds or their provision. Since then, major legislative actions against proliferation financing have been driven by exogenous influences in South Korea, ranging from the UNSCRs to the FATF accession. Table 3 lists the relevant laws and their major components. Given such comprehensiveness of the required measures, the initial phase of implementation in South Korea was weak, if not symbolic. Restrictions on foreign exchange transactions for terrorist and WMD related entities were introduced under the *Foreign Exchange Transactions Act* and 508 transactions have been restricted in accordance with that legislation. However, due to the lack of explicit mechanism for designating entities involved in terrorist or proliferation activities, restrictions applied to only those that were designated by the UN (FATF, 2009). Further, despite the mandate from the UNSCR 1373 and the recommendations from the FATF, South Korea waited until the last minute to introduce the asset-freezing clause, citing the availability of confiscating authority under the *Proceeds of Crime Act*. Before the PFOPIA took effect in 2008, terrorist or proliferation financing had not been treated as predicate offences and broad provisions in *the Proceeds of Crime Act* had to be applied for the punishments. The South Korean government did not take actions to introduce the provisions mandated by the UNSCR 1540 on proliferation financing.⁶ In its official report to the 1540 Committee in 2004 before the enactment of PFOPIA, the South Korean government simply pointed out *the Financial Transaction Reports Act* and *the Proceeds of Crime Act* as adequate legal sources for controlling such funds and services (UNSC, 2004). Given that terrorist or proliferation financing was no predicate offences before the PFOPIA, it is close to judiciously choosing, if not twisting, the facts on the grounds. Accordingly, the FATF in its mutual evaluation report of 2009 noted “the level of sanctions available for breaches of AML-CFT (Anti-Money Laundering and Combating the Financing of Terrorism & Proliferation) obligations is low and sanctions are not often applied by supervisory authorities” (FATF, 2009). More often than not, joining this exclusive club is regarded as a stamp of approval that testifies to the transparency of the domestic financial system, thereby inducing non-members to adopt the standards to enhance their standing in the financial community and

⁵ The initial draft of counter-terrorism bill was introduced and discarded in May 2004 after the term of 16th National Assembly came to an end. The main obstacle to the progress of the draft was the debate over the expanded role of National Intelligence Service. NGOs strongly voiced their concerns over the potential breach of civil rights (The Chosun Daily, 2004).

⁶ The Resolution “decides that all States shall...establish, develop, review and maintain appropriate effective national controls on providing funds and services related to such export and trans-shipment such as financing, and transporting that would contribute to proliferation”

Table 3. A Legislative Chronology on Counter-Proliferation Financing (South Korea)

Trigger Events	<i>S. Korea's Legislative Response</i>	Main Components
UNSCR 1373, 2001 (On Counter-Terrorism after the 9.11 Attacks)	<i>Financial Transaction Reports Act (Enacted, 2001)</i>	Obligation to file suspicious transaction reports over KRW 20 million
	<i>Korea Financial Intelligence Unit (Established, 2001)</i>	The lead agency for anti-money laundering and counter-terrorist financing
	<i>Foreign Exchange Transactions Act (Amended, 2001)</i>	Restriction on transactions by or with non-residents designated by the UNSCRs
UNSCR 1540, 2004	<i>Foreign Trade Act (Amended, 2006)</i>	Establishment of export control regime
FATF Accession, 2009	<i>Prohibition of Financing for Offences of Public Intimidation Act (Enacted, 2007)</i>	Introduction of punishments on terrorist and WMD related financing schemes
	<i>Financial Transaction Reports Act (Amended, 2007)</i>	Inclusion of terrorist and WMD related matters to suspicious transaction reports
	<i>Financial Transaction Reports Act (Amended, 2010)</i>	Obligation to file suspicious transaction reports over KRW 5 million
	<i>Prohibition of Financing for Offences of Public Intimidation Act (Amended, 2011)</i>	Introduction of 'asset freezing' clause for individuals or institutions suspected of terrorist or proliferation activities.

offer their financial firms better access to the international market (Drezner, 2007; Mattli and Buthe, 2003). The FATF combines these presumed benefits with the institutional surveillance to spread its stringent standards devised among a cohesive group of developed countries. Faced with the criticism before its membership accession, the South Korean government promised to amend the existing laws in line with the FATF protocols and did introduce the 'asset freezing' clause in PFOPIA in 2011.⁷ Furthermore, since 2004 the IMF in conjunction with the FATF has made AML-CFT an integral part of its Article IV surveillance on member nations.⁸ In so doing, the IMF raised the stake of the enforcement activities and at the same time strengthened the compliant members' standing in IMF surveillance program. Together, the presumed benefits from joining the exclusive FATF provided the rationale and momentum for the passage and enactment of PFOPIA. It is no coincidence that PFOPIA was enacted in time for the FATF on-site surveillance. It offered *ex ante* benefits that addressed incomplete information problem.

The passage of PFOPIA and its amendments around the accession to FATF have put in place the financial regulations against WMD in line with international standards. However, joining a coalition is one thing and actively implementing a sanction is another (Drezner, 2000; Ouaghran-Gourmley, 2012; Ganguli and Ernoult, 2012). In this light, the case of

⁷ Prohibition of Financing for Offences of Public Intimidation Act (<http://likms.assembly.go.kr/>)

⁸ It provides "a framework to deal with cases where money laundering, terrorist financing, and related crimes are so serious as to threaten domestic stability, balance of payments stability, and the effective operation of the international monetary system" (IMF, 2012).

South Korea's passive attitude regarding non-proliferation financing was turned upside down around the Bank Mellat fiasco in 2010 when 'secondary sanctions' from the U.S. became a real possibility. As *Table 4* shows, the trouble started with the latest UN sanctions on Iran's nuclear program in June 2010. The UNSCR 1929 imposed further restrictions on Iran's financing its alleged nuclear program, on top of the long standing list of sanctions already in place.⁹ In its Annex, a subsidiary of Bank Mellat in Malaysia was designated for its involvement in proliferation and the Bank's role in facilitating funds for Iranian nuclear entities was noted. Bank Mellat has been running its only Asian office in Seoul since 2001. Although the U.S. Treasury added Bank Mellat to the Specially Designated National (SDN) list upon Executive Order 13382 in 2005 and kept warning the South Korean government on the Bank's ties to Iranian nuclear programs, the South Korean government found comfort in the fact that the Bank's Seoul branch was not on the list of UNSCR 1929.¹⁰ Soon thereafter in July, however, the U.S. Congress ratcheted up its pressure against Iran by passing the *Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010* (CISADA). The Act expands many existing restrictions and includes new provisions designed to reach foreign firms currently doing business with Iran. As with Executive Order 13382, it threatens to sanction foreign banks doing business with the designated Iranian banks. It effectively increased *ex post* costs on the financial institutions in the U.S. and follower nations. Moreover, the implementing regulations of CISADA sanctioned Bank Mellat Seoul in October and demanded its shutdown to the South Korean government. Given the potential for damages affecting South Korean banks and companies doing business with the Bank, the South Korean government decided to impose its own sanctions on Iran and suspended Bank Mellat Seoul branch on 8th of September. Under the new sanctions, 126 Iranian individuals and companies were banned from exchange transactions with South Korea. They also prohibit building contracts and new investment in Iran, as well as the provision of technical and financial services that would benefit Iran's energy sector (King and Spalding, 2010). The sequence of actions leading up to the Bank Mellat Fiasco in 2010 is clearly in sync with the Bayesian equilibrium model developed in Figure 2. First, the structure of a dynamic incomplete information game with infinite iterations is adequate for explaining the sender-follower relationship in South Korea's joining the financial sanctions against Iran. A hesitant follower like South Korea would weigh the value of future gains against costs from joining the bandwagon without knowing for sure the degree of determination of the sender. Unless South Korea has a strong belief in the sender being a hawk, as in the range V in Figure 3, she would not comply in a 'normal type' enforcement game against the sender. As noted, the South Korean government introduced counter-proliferation financing measures required by the successive UNSCRs only to fall short of active implementation thereof. Second, a sender offers a potential reward from adopting counter-proliferation financing measures in the form of institutional 'issue-linkage' - a FATF membership and the IMF inclusion of AML-CFT in its surveillance for South Korea. A hesitant South Korea reads this signal and in turn adjusts its belief of the sender's type β , more likely to be a hawk by the size of III and IV, and chooses compliance as its equilibrium strategy. The passage of the single most important legislation in this area, PFOPIA, right before the FATF accession in 2009 clearly testifies to

⁹ Since 2006, there have been seven separate resolutions – 1696 (2006), 1737 (2006), 1747 (2007), 1803 (2008), 1835 (2008), 1887 (2009), 1929 (2010) – from the Security Council on Iran's nuclear program.

¹⁰ From interviews with Foreign Ministry officers of South Korea.

Table 4. The Bank Mellat Fiasco (2010)

<i>UNSCR 1929 (June, 2010)</i>	- “First East Export Bank, PLC is owned or controlled by, or acts on behalf of Bank Mellat. Over the last seven years, Bank Mellat has facilitated hundreds of millions of dollars in transactions for Iranian nuclear, missile, and defense entities” (Annex I).
<i>US enactment of CISADA (July, 2010)</i>	- “The Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010” (CISADA) severely constrains U.S. banks from engaging in financial transactions with foreign banks doing business with designated Iranian banks. - Bank Mellat was designated in 2008 by the U.S. Treasury for its linkage to Iranian nuclear program, based on Executive Order 13382.
<i>U.S. Political Pressure (July- September, 2010)</i>	- U.S. notified South Korea that Bank Mellat Seoul branch has been facilitating financial transactions for Iranian nuclear programs and demanded its shutdown. - Robert Einhorn, Obama’s Special Advisor for Non-proliferation and Arms control, visited Seoul in August 2001 and explained the specifics of CISADA.
<i>South Korea Sanctions Iran (September, 2010)</i>	- South Korea issued a two-month suspension on Bank Mellat Seoul branch and banned financial transactions on 102 Iranian entities and 24 individuals.

that effect.

Third, a credible threat of additional sanctions from the sender would further increase the perceived likelihood of a hawkish behavior from the sender, the sum of II, III, IV and V. As a result, South Korea is more likely than under any other specifications above to choose compliance as its equilibrium strategy. In fact, despite this institutional ‘issue-linkage’, it was not until the passage of CISADA and when the U.S. banged its door that the South Korean government started actively implementing what was already in the books (Table 4). The Financial Supervisory Service of South Korea, its regulatory agency, cited the illegal transactions between Bank Mellat Seoul and Bank Saderat, UNSCR designated entity, as the reasons for suspending its operations (Donga Daily, Sep. 28, 2010). It is noteworthy that the U.S. threat of secondary sanctions through CISADA was only heard in South Korea after she joined the FATF and had PFOFIA in place. A series of on-going U.S. financial sanctions against third party collaborators to Iran’s nuclear ambition does not seem to have affected the South Korea’s perception of the sender’s type β . As shown in Figure 3, as far as the cost of additional sanction y_B is perceived to be smaller than the potential benefit from issue-linkage x , F is less likely to choose compliance strategy when faced with a ‘threat’ game than with an ‘issue-linkage’ game given incomplete information about the sender type β . Between traditional allies such as the U.S. and South Korea, this is more than likely given the inherent political discretions involved in actual implementation of secondary sanctions. Moreover, South Korea imported about 10% of their entire crude oil needs from Iran and had the biggest share of home electronics market in Iran (Wu and Morrison, 2007). Relying exclusively on the existing UNSCR designation process to sanction any Iran-related entities or individuals, South Korea found refuge in the mandatory nature of such actions with respect to the diplomatic and commercial relations with Iran. Given that UNSCR designation process is cumbersome and time consuming, it would raise the cost of enforcement (d) in a ‘normal type’ game only to reduce F ’s (in this case South Korea’s) compliance rate $q = (b-d)/b$ (Table 2). On the other hand, F will have every incentive to accept an ‘issue-linkage’

offer as the equilibrium Nash payoff from doing so is larger than a 'normal type' enforcement game by the size of x (*Table 2*). Without a doubt, S will witness more of F 's compliance if it were to present 'issue-linkage' and a 'threat' simultaneously. However, it is unlikely that this is a feasible option in actual cases since 'issue-linkage' (FATF) and a 'threat' (U.S. Congress) originate from two different sources and the FATF has hardly exercised its 'naming and shaming' strategy against its own member jurisdictions (IMF, 2013).

4. CONCLUSION

This paper applies a Bayesian equilibrium model to address the sequencing of the two main factors that contribute to 'coercive cooperation' by showing how to combine 'issue-linkage' and 'audience costs' in order to maximize purported cooperative effect. Unlike the game of complete information where a follower would increase its equilibrium compliance rate with larger 'audience costs' in the form of a 'threat', it is more likely in a game of incomplete information to show higher compliance by accepting 'issue-linkage' than a 'threat' when the perceived cost from the threat is smaller than the presumed benefit from 'issue-linkage'. A leading sender in a sanctioning coalition will then have a strong incentive to add a 'threat' to bring about the maximum compliance from the follower. However, starting with a bigger stick will increase the expected compliance rate from the follower and subsequently reduce the enforcement rate in equilibrium, thereby leaving the Nash payoffs unchanged for both players. Our model's predictions have been borne out by the case study on South Korea. In response to WMD financial sanctions against Iran, the government of South Korea accepted institutional issue-linkages, voluntary accession to the FATF in the case of Iran sanctions. Soon thereafter, the U.S. passed new legislations with strong 'secondary sanctions' clauses, a credible 'threat' with the self-imposed 'audience costs'. Once in a bandwagon through tactical issue-linkages, the government of South Korea actively implemented enforcement measures, the suspension of the Iranian Mellat Bank in Seoul. For a leading sender like the U.S., the strategic benefits from institutional 'issue-linkage' do not stop with higher cooperation and enforcement. South Korea was among the among the first 12 donors collectively providing \$27.3 million to strengthen the AML-CFT(Anti-Money Laundering and Combating the Financing of Terrorism & Proliferation) regimes in 'Topical Trust Fund' of the IMF.¹¹

Although the evolution of South Korea's nonproliferation financing regime and its sudden change of course in implementation provides partial evidence for the validity of the model, one case study can hardly prove it. To do so, one needs to test the hypotheses derived from the model with sanctions database with a larger number of noncompliance episodes. Notwithstanding this important shortcoming, this paper examines the 'black box' of sender dynamics in a different light from the previous studies. It builds on the existing works on the role of international institutions in sanctioning coalitions and tackles the two perennial themes in coercive cooperation, 'time inconsistency' and 'incomplete information', separately, instead of lumping them together.

¹¹ In April 2009, the IMF launched its first, donor-supported 'Topical Trust Fund' in the area of AML-CFT. Switzerland, Norway, the UK, Canada, Kuwait, Qatar, Saudi Arabia, Japan, Luxembourg, the Netherlands, Korea, and France comprise the entire list of donors that started the first 'Topical Trust Fund' of its kind in the area of AML/CFT.

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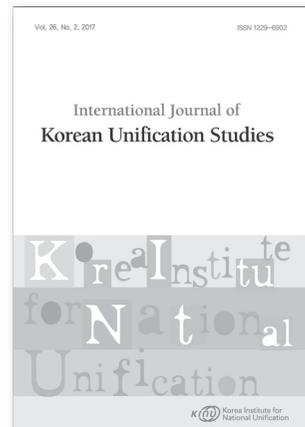
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