IRAN TASK FORCE

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Iran Turns to China, Barter to Survive Sanctions

The Context

Sanctions and China's growing economic clout have altered Iran's trading patterns in ways that are reducing Iran's access to hard currency but may also be insulating the Iranian government and political elite from further US unilateral pressures.

New statistics show Iran's growing dependence on China both as a market and as a source of consumer and industrial goods. While Iranians generally prefer European suppliers, they are adapting, and are likely to be able to continue to do so as long as demand remains strong for Iran's oil and natural gas. Proposed new US sanctions, such as forbidding dealings with Iran's Central Bank, will propel Iran even more toward China, barter arrangements, front companies, and smuggling. China, Turkey, India, and even the European Union, which have embraced more aggressive penalties against Iran in recent years, may not follow Washington's lead, undermining the multilateral coalition that has developed against Tehran over the past two years.

As the US Congress and administration contemplate further measures to increase pressure on Iran, they should focus on improving implementation of existing sanctions that target nuclear proliferation and human rights abusers rather than Iranians in general. They should be aware of the unintended consequences of broader sanctions in terms of upsetting world oil markets, entrenching illegal practices and unsavory actors in Iran, and alienating middle-class Iranians who have been the most supportive of improved ties with the West.

About the Atlantic Council's Iran Task Force

The Iran Task Force, co-chaired by Ambassador Stuart Eizenstat and Senator Chuck Hagel, seeks to perform a comprehensive analysis of Iran's internal political landscape, as well as its role in the region and globally, to answer the question of whether there are elements within the country and region that can build the basis for an improved relationship with the West and how these elements, if they exist, could be utilized by U.S. policymakers. Launched in February 2010, the Task Force has hosted eight briefings with experts addressing key issues such as "Iran's Regional Role," "Foreign Policy Choices Within Iran," "Iran's Nuclear Capabilities and Strategic Goals," and "Negotiating with Iran in an International Context."

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The Issue

Over the past two years, as US and UN penalties against Iran over its nuclear program have escalated, Iran has lost access to most Western banks and has turned increasingly to bartering oil for goods from China. Iran has also increased trade with Turkey, India, Iraq and Afghanistan while maintaining significant, albeit reduced, economic ties with the United Arab Emirates, Japan, South Korea, and members of the European Union, especially Germany and Italy.

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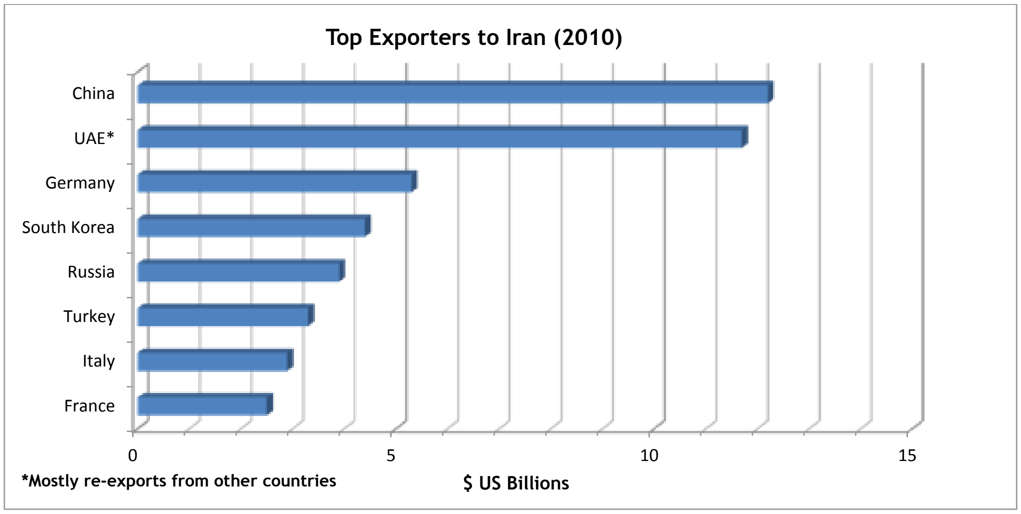
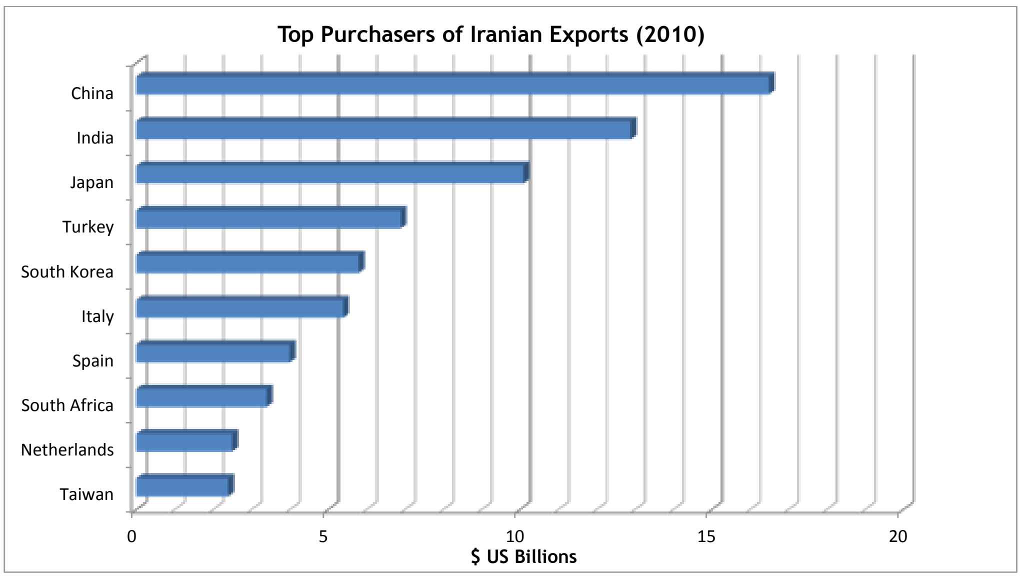


Source: International Monetary Fund Country Data, 2011.

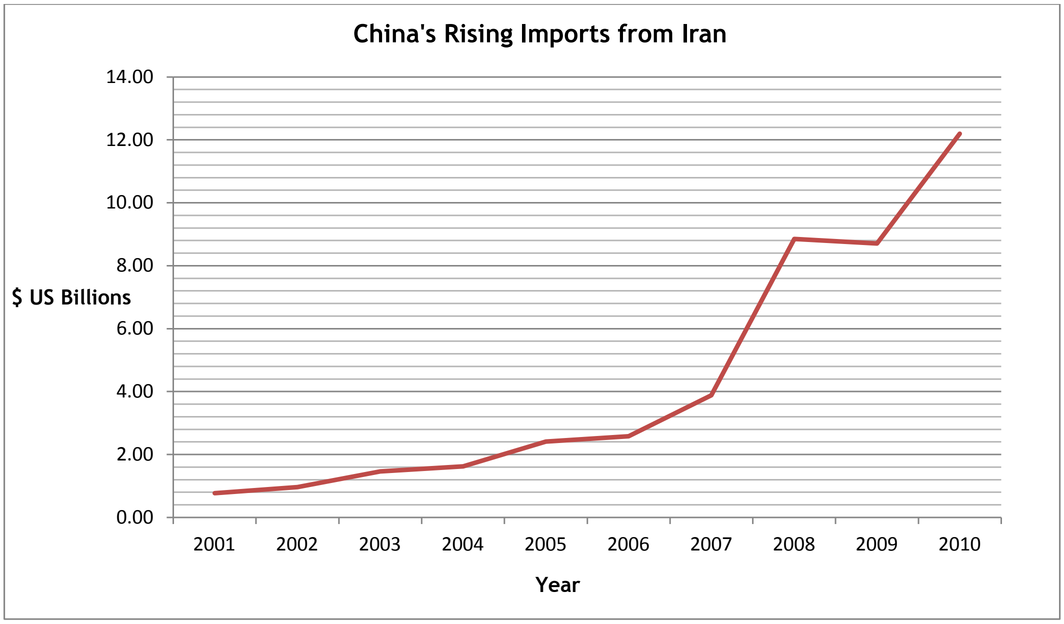


Source: International Monetary Fund Country Data, 2011.

The new trading patterns have come at a cost to the Iranian economy. Purchasers of Iranian oil have been able to demand deep discounts; some have had difficulty reimbursing Tehran through the international banking system. This has forced Iran to resort to barter deals and other transactions that have reduced its access to hard currency—a shortage that has been reflected in volatile swings in the Iranian rial and a growing gap between its official and black-market rates. While Iran's economy is still growing by 2 to 3 percent a year according to the International Monetary Fund, the level is not sufficient to stave off high unemployment, particularly among the young. Corruption is also on the rise as Iranian domestic actors compete for scarce resources; this has become an increasingly contentious issue in Iran's unsettled domestic politics. Nevertheless, Iran appears to have sufficient reserves to pay off key constituencies and keep a lid on popular unrest.

This issue brief will examine Iran's trade with China, India, and Turkey, which together accounted for nearly a third of Iran's external commercial activity in 2010.[1] It will also discuss a major Iranian supplier, Germany, which has sought to maintain trade with Tehran in the face of growing obstacles. The brief will summarize the impact of sanctions and discuss new measures introduced into the US Congress. Finally, it will suggest policies most likely to squeeze the Iranian nuclear program and punish Iran's poor conduct in the area of human rights, with the fewest negative consequences for the global economy and the Iranian people.

[1] See charts on this page and page 3.



Source: International Monetary Fund Country Data, 2011.

Growing Dependence on China

The big story of the last decade for Iranian trade has been that of increasing reliance on China. Since 2001, Chinese exports to Iran have increased nearly sixteen-fold, to $12.2 billion, while Iranian exports to China last year amounted to $16.5 billion, primarily crude oil. China's trade with Iran accounts for nearly 18 percent of Iran's total commerce, and is second only to that with the entire twenty-seven-member European Union.[2]

Bijan Khajehpour, a veteran Iranian business consultant now based in Vienna, said that Iran often does not receive hard currency for its exports to China. "The accounts stay in China and [the money] is spent on imports," he said.[3] Iranians grumble about this dependency and would prefer more Western European technology, but the Iranian economy continues to function, albeit less efficiently. Much of the trade is conducted by Iranian state-run companies, semi-governmental bodies, and firms controlled by the Revolutionary Guards, which have taken over large chunks of the Iranian economy in recent years. The Chinese government actively promotes Iran trade; its commercial delegations even stay at the compound of the Chinese ambassador in Tehran and do not interact with the Iranian public, Khajehpour said. The resulting deals are opaque and subject to corruption.[4]

As controversy over Iran's nuclear program has grown, China has sought to diversify its oil imports, buying more from other suppliers, including Angola and Saudi Arabia.[5] The largest foreign investor in Iran's energy sector, China has slowed implementation of an estimated $40 billion in promised investments in return for an agreement with the Obama administration not to sanction Chinese energy companies under the Comprehensive Iran Sanctions, Accountability and Divestment Act (CISADA).[6] This legislation, enacted in 2010, calls for mandatory investigations of foreign companies that sell Iran gasoline and other refined petroleum products and threatens to bar them from the US market. So far, the US government has sanctioned ten companies under the law, none of them Chinese, even though China supplies a third of Iran's gasoline imports, according to the Foundation for Defense of Democracies, a Washington-based think tank that provides research for congressional staffers crafting sanctions legislation.

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2 Ibid.

3 Khajehpour spoke at a conference of the National Iranian American Council on October 4, 2011 (**www.niacouncil.org/site/PageNavigator/About/LeadershipConference.html**).

4 Khajehpour made these comments at a symposium at the Woodrow Wilson International Center for Scholars on September 30, 2011 (**www.wilsoncenter.org/event/iran-turmoil-home-assertiveness-abroad**).

5 E-mail to author from John Garver, an expert on Iran and China at the Georgia Institute of Technology, April 29, 2011.

6 Barbara Slavin, "Iran Sanctions: Preferable to War but No Silver Bullet," Atlantic Council Iran Task Force, June 2011 (**www.acus.org/files/publication_pdfs/403/060211_ACUS_Slavin_SilverBullet.pdf**).

Queried about this recently, Undersecretary of State for Political Affairs Wendy Sherman told the Senate Banking Committee that China "has exercised restraint" in regard to Iran's energy development. She said the Obama administration had "seen reports that . . . Chinese companies have not finalized any new upstream or refinery projects [in Iran] since the enactment of CISADA."[7] Of the $40 billion in announced China-Iran energy investment deals, less than $3 billion appears to have actually been provided.[8]

However, there are clear limits to how far China will go in squeezing Iran. China's rapidly growing economy requires ever greater sources of energy, and Chinese officials do not want to alienate the world's second-largest oil producer after Saudi Arabia and the possessor of the second-largest natural gas reserves after Russia. Beijing also regards Iran as an important regional power. Iran has shown its ability to influence neighbors for good and for ill, and could wreak havoc on Arab Gulf oil producers if it chose.

John Garver, a specialist on Iran and China at the Georgia Institute of Technology, has argued that China is playing a "dual game," seeking to retain access to Iranian oil while remaining on good terms with the United States.[9] Thus Beijing recently invited senior staff of the Atlantic Council and other American think tanks to a conference entitled, "Potentialities of US-Chinese Cooperation in Central Asia and the Middle East," at which officials pledged to work with the United States on issues of common interest in this region. On the other hand, despite voting in favor of UN sanctions that target Iran's state-owned Islamic Republic of Iran Shipping Lines (IRISL), China has facilitated circumvention of these measures. According to an investigation by the *South China Morning Post*, "IRISL continues to operate on the mainland under a network of aliases and companies, which includes [at least 20] ships and companies registered in Hong Kong."[10] China has also acted to prevent the disclosure of information that could deepen Iran's isolation, blocking publication of a UN panel report that suggested North Korea and Iran have used China as a transshipment point for illegally sharing ballistic missile technology.[11] And China has lobbied the International Atomic Energy Agency not to reveal more evidence about alleged Iranian research into nuclear weapons technology—actions that could provide the basis for more sanctions.[12]

While China would prefer Iran not to develop nuclear weapons for fear of making the Gulf region even more unstable, China does not feel threatened by the prospect of a nuclear weapons–capable Iran. According to Garver, some elements in the Chinese defense establishment would actually prefer a nuclear Iran—or at least an Iran that seems on the verge of acquiring nuclear weapons—if that compels the United States to retain substantial military forces in the Gulf rather than East Asia.

A "Core Energy Partner" for India

Another Asian magnet for Iranian oil is India, whose economic growth over the past decade has averaged 7.6 percent a year, second only to that of China.[13] India and Iran share a desire for geopolitical independence from established big powers. The two are further bound by common concerns over the consequences of US withdrawal from Afghanistan. While Iran accounts for only about 8 to 10 percent of India's oil imports, India is determined to maintain the relationship with such a conveniently located and strategically important supplier, said Harsh V. Pant, an expert on India and Iran at King's College London. "There are lots of problems, but Iran remains a core energy partner for India," he said.[14]

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7 Undersecretary of State for Political Affairs Wendy Sherman, testimony before Congress, October 13, 2011 (**http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=1a1490a0-e9aa-4daa-bd82-66b59668ad19**).

8 "Iran Suffers under Sanctions, Faces Threat of More," Agence France Presse, October 16, 2011 (**www.channelnewsasia.com/stories/afp_world_business/view/1159701/1/.html**).

9 John W. Garver, "Is China Playing a Dual Game in Iran?," *The Washington Quarterly*, Winter 2011 (**www.twq.com/11winter/docs/11winter_Garver.pdf**).

10 Patricia Chan and Irene Jay Liu, "Iranian Line to China Sails by a New Name," *South China Morning Post*, October 27, 2011 (**http://topics.scmp.com/news/iranshellgame/article/Iranian-line-to-China-sails-by-a-new-name**).

11 Louis Charbonneau, "China Blocks UN Report on N. Korea-Iran Ties: Envoys," Reuters, May 17, 2011 (**www.reuters.com/article/2011/05/17/us-korea-north-un-china-idUSTRE74G66J20110517**).

12 George Jahn, "Note Shows Big Power Split over Iran," Associated Press, October 24, 2011 (**www.google.com/hostednews/ap/article/ALeqM5hK4Hj4iWKLEbTKhLQWhtHB2Bj-tw?docId=f47e061303e2454aab0a032f6f0b8d92**).

13 "The United States and India: A Shared Strategic Future," Council on Foreign Relations / Aspen Institute India, September 2011 (**www.cfr.org/india/united-states-india-shared-strategic-future/p25740**).

14 Telephone interview with the author, October 21, 2011.

India, like China, has an ambivalent view of sanctions against Iran's nuclear program, having been the victim of substantial penalties in the past for its own diversion of a civilian nuclear infrastructure to weapons. However, it has had to accommodate US regulations that forbid dealing with Iran in dollars and threaten to bar foreign energy companies from business in the United States if they also sell refined petroleum products to Tehran.

Under US pressure, India's Reliance Industries pulled out last year from refining Iranian crude. A twenty-five-year, $22 billion liquefied natural gas (LNG) deal signed in 2005 has also not been implemented because it would require India to construct an LNG plant in Iran that would include US components. Also in limbo is a $7 billion scheme to build a 1,700-mile pipeline to bring Iranian gas to India via Pakistan.[15]

Compounding the complications on trade with Iran are US banking sanctions which have made it difficult for India to pay for Iranian oil. Earlier this year, under US pressure, India stopped using the Asian Clearing Union, a Tehran-based financial institution set up before the 1979 Islamic revolution, to pay its bills. India sought to use an Iranian bank based in Germany, Europaeisch-Iranische Handelsbank AG (EIH), but was blocked after the European Union froze the bank's assets out of concerns that it was being used to finance proliferation.[16] India finally managed to settle most of the $4 to $5 billion debt through a Turkish state-owned bank, Halkbank. According to recent reports in the Indian media, the Central Bank of Iran plans to open accounts with two Indian banks—state-run IDBI Bank Ltd. and UCO Bank—so that India can pay 20 percent of its oil bills in rupees, a nonconvertible currency.[17] Pant said India is looking for long-term arrangements, and is also considering paying Iran with local currencies through banks in South Korea and Russia.[18]

Such hurdles have encouraged India to deepen its commercial relationships with other oil suppliers, particularly Saudi Arabia. India is now the fourth-largest customer for Saudi oil, and its imports are likely to double over the next twenty years, according to Pant. Overall, the six Arab countries of the Gulf Cooperation Council provide nearly half of India's oil imports, while Qatar sells India liquefied natural gas. Partly as a result, India's trade with the GCC is rising rapidly, from $5.6 billion a decade ago to more than $130 billion projected for 2013–14.[19]

That India has managed to build good relations with Saudi Arabia while developing ties with Israel and maintaining links to Iran is a diplomatic trifecta that reflects both India's political skill and the lure of its robust economy. India does not see these relationships as zero-sum. Beyond diversifying energy sources, India views continued good relations with Iran as a hedge against the resurgence of Pakistan-backed Taliban in Afghanistan, a development which India sees as likely as the US withdraws combat troops.

India and Iran have a history of collaborating on Afghanistan, as they were both major backers of the anti-Taliban Afghan Northern Alliance during the previous Taliban reign in the 1990s. India has cemented its ties with both Iran and Afghanistan by building a new port at the Iranian town of Chabahar on the Gulf of Oman that enables it to circumvent Pakistan to trade with Iran, Afghanistan, and Central Asia. The port is connected by road to the Afghan border at Zaranj, where it meets the Afghan ring road between Herat and Kabul at Delaram.[20] The Zaranj-Delaram highway was built by the Indian Border Works Organization, a subsidiary of the Indian army.[21] "India would not like to lose Iran," Pant said. "India is preparing for the worst case if the US completely withdraws from Afghanistan. India should have an alternative arrangement."[22]

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15 Harsh V. Pant, "India's Relations with Iran: Much Ado about Nothing," *The Washington Quarterly*, February 2011 (**www.twq.com/11winter/docs/11winter_Pant.pdf**).

16 "Germany EIH Bank Takes Legal Move to Unfreeze Assets," Reuters, September 23, 2011 (**www.reuters.com/article/2011/09/23/eu-eihbank-idUSL5E7KN41320110923**).

17 "Iran to Open Accounts with Indian Banks for Oil Payment," Reuters, October 12, 2011 (**http://in.reuters.com/article/2011/10/12/idINIndia-59850820111012**).

18 Telephone interview with the author, October 21, 2011.

19 Pant, "India's Relations with Iran: Much Ado about Nothing" (**www.twq.com/11winter/docs/11winter_Pant.pdf**).

20 Barbara Slavin, " 'Strategically Lonely' Iran Exploits Opportunities for Regional Influence," Atlantic Council Iran Task Force, March 2011 (**www.acus.org/files/publication_pdfs/403/032511_ACUS_Slavin_LonelyIran.PDFhttp://www.acus.org/files/publication_pdfs/403/032511_ACUS_Slavin_LonelyIran.PDF**).

21 "India Builds Important Road-Link Joining Afghanistan with Iran," *Payvand News*, December 20, 2007 (**www.payvand.com/news/07/dec/1204.html**).

22 Telephone interview with the author, October 21, 2011.

Turkey's Balancing Act

The Turkish-Iranian relationship is also built on a foundation of energy and geopolitics. Seventy percent of Turkey and Iran's $10 billion annual trade is in the form of Iranian natural gas, which makes Iran Turkey's second-largest supplier after Russia.[23] In return, Turkey sells Iran a wide variety of products, including machinery, automobiles, textiles, and fruit. Turkey is loath to alienate Iran when so much of the region is in flux and Iran can hurt Turkey by supporting Kurdish militants.

The Turkish government has sought to bolster trade with Iran even while it abides by UN sanctions. Prime Minister Recep Tayyip Erdogan said last year that Turkey hopes to triple commerce with Iran by 2015.[24] Although a number of Turkish banks have stopped dealing with Iran, the state-run Halkbank facilitated India's settlement of its oil debts to Iran.[25]

Kadir Ustun, research director in Washington for SETA DC, a think tank focusing on Turkish foreign policy, said that Turkey views the relationship with Iran as an important source of leverage, and that Turkey's goal is to help Iran integrate into the region's economy. But "Iran does not make it easy," Ustun said, referring to the difficulty Turkish businesses face in reaching and implementing contracts with Iranian entities.[26]

Big Turkish companies have had unhappy experiences in Iran. In 2004, the Iranian Revolutionary Guards blocked the scheduled opening of the new Imam Khomeini International Airport outside Tehran to prevent a Turkish consortium, TAV, from carrying out its contract to operate the airport.[27] The Guards, who were dramatically expanding their economic role in Iranian society at the time, wanted control of lucrative airport operations and duty-free sales for themselves. The following year, the Iranian government abruptly canceled another major contract, with the Turkish mobile phone operator, Turkcell.[28]

Smaller Turkish companies also complain that "Iranians are not reliable and do not abide by contracts and pay on time," said Omer Taspinar, an expert on Turkish foreign relations at the Brookings Institution. He said the Turkish government was hoping to reduce dependency on Iranian natural gas, looking toward Turkmenistan, Azerbaijan, and Algeria.[29] Meanwhile, the Turkish company Tupras stopped supplying Iran with gasoline after the passage of CISADA.[30]

Despite Erdogan's proclaimed desire to insulate economics from politics, new strains between Turkey and Iran as a result of the Arab Spring are also likely to undermine efforts to expand the bilateral commercial relationship. Turkey and Iran are now on opposite sides when it comes to Syria, with Erdogan calling for Syrian president Bashar al-Assad to step down and Iranian leaders seeking to bolster the Syrian's hold on power in the face of persistent civil unrest.

Erdogan's recent claims that Turkey represents a model for a democratizing Arab world irritated Iran, which asserts that Arab activists were inspired by its 1979 Islamic revolution. Iran has also reacted angrily to Turkey's recent decision to allow radar to be stationed on its soil as part of a NATO missile defense scheme. Turkey lobbied hard to have NATO declare that Iran was not the target of the radar, but the reality is otherwise. One Iranian newspaper, *Javan*, editorialized recently that Turkey's actions "clearly show that Turkey is the United States' agent in the region." [31]

In hindsight, it appears that Turkey-Iran relations may have peaked in 2010, when Turkey and Brazil sought to mediate a confidence-building measure with Iran over its nuclear program. The resulting Tehran Declaration—which would have sent out a portion of Iran's stockpile of low-enriched uranium in return for fuel for a reactor that makes medical isotopes—was rejected by the United States as an Iranian ploy to stave off more sanctions. The Tehran deal, followed by Turkey's decision to vote against new UN sanctions

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[23] Statistics provided by Turkish official to author, October 19, 2011.

[24] Thomas Grove, "Turkey's PM Tells Businessmen to Boost Iran Trade," Reuters, September 16, 2010 (**www.reuters.com/article/2010/09/16/turkey-iran-trade-idUSLDE68F18F20100916**).

[25] "Iran to Open Accounts with Indian banks for Oil Payment," Reuters, October 12, 2011 (**http://in.reuters.com/article/2011/10/12/idINIndia-59850820111012**).

[26] Interview with the author, October 20, 2011.

[27] Kamal Nasir Yasin, "Iran's Revolutionary Guards Making a Bid for Increased Power," Eurasianet.org, May 18, 2004 (**www.eurasianet.org/departments/insight/articles/eav051904a.shtml**).

[28] "Turkcell Fights for Iran Deal," *New York Times*, October 16, 2005 (**www.nytimes.com/2005/10/16/business/worldbusiness/16iht-hot.html**).

[29] Interview with the author, October 21, 2011.

[30] "Turkey's Tupras to Discontinue Activities in Iran," *Hurriyet Daily News*, October 1, 2010 (**www.hurriyetdailynews.com/n.php?n=tupras-to-discontinue-its-activities-in-iran-2010-10-01**).

[31] Editorial in *Javan*, October 17, 2011, translated by Mideast Mirror, a subscription translation service based in London.

against Iran, caused severe strains between Ankara and Washington—strains that were exacerbated by a crisis in relations between Turkey and Israel over the latter's treatment of Palestinians in Gaza.

However, the Arab Spring has brought a renewal of US-Turkish collaboration. Both have embraced the uprisings in Egypt, Tunisia, and Libya, and Washington appreciates Ankara's ability to bolster new Arab democracies and to help determine the future of Syria and Iraq. But Turkey cannot tilt completely away from Iran, which retains the power to influence Turkey's most sensitive domestic and foreign policy issue—the fate of its Kurdish minority. Turks were outraged by recent reports that Iran captured and then freed a senior figure in the Kurdistan Workers' Party, or PKK, which has fought a prolonged guerrilla war against Turkey.[32] After a PKK attack killed nearly thirty Turkish soldiers and police, the Turkish and Iranian foreign ministers met in Ankara and pledged cooperation against terrorism.[33] Still, Turkey is likely to remain wary of Iranian promises. Henri Barkey, an expert on Turkey at Lehigh University, said he believes that both "the Iranians and Syrians are using hardliners in the PKK to warn Erdogan not to do too much [to support the opposition] in Syria."[34]

Germany Remains a Major Supplier

While Iran has increasingly looked to its neighbors and to China and India for new trade opportunities, it has not given up on Europe. US pressure over the years has pushed many Europe-based multinationals and large banks to quit Iran, or at least to curtail new business. However, Iran-German trade remains relatively robust, propelled by small- and medium-sized German firms that continue to supply the Iranian market. Iranians have a high regard for German products, and Germany's $5.3 billion in exports to Iran last year included machinery, iron and steel products, auto parts, and chemicals, according to a European diplomat in Washington who asked not to be named.[35]

Critics of German-Iranian trade have focused on controversial exports by companies such as Siemens, which, in a joint venture with the Finnish company, Nokia, supplied Iran in 2008 with technology that Iran used to spy on its own people during protests following disputed 2009 presidential elections.[36] There was also an outcry when India sought to use EIH bank, based in Hamburg, to settle its oil debts with Iran.

Benjamin Weinthal, a fellow with the Foundation for the Defense of Democracies based in Germany, noted that the European Union overall remains Iran's biggest trading partner, and that for many German companies, "it's business as usual. All these mid-level engineering companies form the bulk of the trade." He added, "Many are wittingly or unwittingly violating sanctions through middlemen in Dubai or Russia."[37] One example: the 2007 arrest and subsequent conviction of Mohsen Vanaki, a German-Iranian trader, on charges that he tried to buy dual-use equipment—including specialized radiation detectors in Germany—for Iran's nuclear program, using front companies in the United Arab Emirates.[38]

However, Iran-German trade has declined since a peak in 2005; a slight increase in 2010 from 2009 reflects the higher price of oil, according to the European diplomat quoted earlier. The diplomat said that for the first six months of 2011, Italy—a bigger purchaser of Iranian oil—has been Iran's top European partner, with Iran-Italy trade amounting to 3.4 billion euros, compared to 1.8 billion euros for Germany and Iran.

US sanctions have played a role in convincing German energy companies to stop or scale back dealings with Iran. Undersecretary of State Sherman noted in her recent testimony that "Germany's Linde, the only supplier of gas liquefaction technology to Iran, stopped all business with it."[39]

Pluses and Minuses for Iran

There is no doubt that sanctions have taken a toll on the Iranian economy, especially the energy, financial, and

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[32] Emre Uslu, "PKK-Iran Axis," *Today's Zaman*, October 5, 2011 (**www.todayszaman.com/columnist-258996-pkk-iran-axis.html**).
[33] Emre Peker, "Turkey to Work with Iran amid Attack against PKK in North Iraq," *Bloomberg Businessweek*, October 21, 2011 (**www.businessweek.com/news/2011-10-21/turkey-to-work-with-iran-amid-attack-against-pkk-in-north-iraq.html**).
[34] Interview with the author, October 11, 2011.
[35] Interview with the author, October 21, 2011.
[36] Eli Lake, "Fed Contractor, Cell Phone Maker Sold Spy System to Iran," *Washington Times*, April 13, 2009 (**www.washingtontimes.com/news/2009/apr/13/europe39s-telecoms-aid-with-spy-tech/?page=all**).
[37] Interview with the author, October 12, 2011.
[38] Barbara Slavin, "How Reliable Is Intelligence on Iran's Nuclear Program?" Atlantic Council Iran Task Force, September 2011 (**www.acus.org/files/publication_pdfs/403/091511_ACUS_IranNuclear.PDF**).
[39] Sherman testimony before Congress, October 13, 2011.

transport sectors. No country—with the recent exception of Syria and Moammar Gadhafi's Libya—has faced such broad and tough penalties on its commercial activities.[40] Iran cannot legally purchase or sell weapons, and its airlines and shipping companies are increasingly barred from foreign ports. CISADA has also had a chilling effect on foreign investment in Iran's energy sector. David Cohen, undersecretary of the Treasury for terrorism and financial intelligence, testified recently that, as a result of foreign companies withdrawing investment from Iran, Iranian oil production was likely to decline by about 800,000 barrels per day by 2016, a 20 percent drop. "At current oil prices, such a decline will cost Iran on average about $14 billion [about 3 percent of Iran's GDP] in annual oil revenues through 2016," he said.[41]

Yet sanctions have not achieved their declared goal of convincing Iran's leaders to end their apparent pursuit of nuclear weapons capability—even as it seems to have exacerbated other disagreements among the elite. Having faced sanctions of one sort or another for thirty-one of its thirty-two years, the Islamic Republic of Iran has developed enormous creativity and flexibility in circumventing such restrictions. The latest penalties have contributed to distortions in the economy that favor the Revolutionary Guards and other state-run or semi-state-controlled entities with privileged access to hard currency. The Guards also make use of clandestine ports to transport goods and cash.

The sanctions have dented Iran's ability to be paid in dollars or euros for its exports. Khajehpour, the expert on the Iranian economy cited earlier, said this was a factor in the government's inability to maintain a stable exchange rate for the rial. There have been sudden fluctuations in the value of the Iranian currency over the past two years, and recently, a yawning gap between the official rate of about 10,500 rials to the dollar and the black-market rate of 13,000. Khajehpour said that sanctions are making imports 5 to 10 percent more expensive. Other signs of economic weakness, he said, were a record amount of bounced checks—$25 billion worth, or 7.5 percent of the money supply—in the last twelve months.[42] The Iranian government has also drained a fund that held surplus oil payments to pay for a reform program that has substituted cash handouts to 80 percent of Iranians for subsidies on gasoline, electricity, and other consumer staples. The reforms, while reducing energy consumption, have so far cost the regime more money than the original subsidies.[43]

But sanctions have also had unintended consequences that have not all been negative for Tehran. Khajehpour said that as a result of US success in blocking Iran from transactions in dollars, the Iranian government in 2008 converted $70 billion in cash reserves to gold that is worth twice as much today.[44] As for the future, Khajehpour said Iran was adapting to the withdrawal of foreign energy firms by developing its own capacity, even in such technically challenging areas as producing liquefied natural gas. He also disagreed with the US assessment that Iran would not be able to maintain production of about 3.8 million barrels of oil a day. Iran is both losing and adding 200,000 to 250,000 barrels a day of new capacity each year, he said.[45]

The economic pressures on Iran have contributed to splits within the elite and to corruption, as businessmen compete for scarce hard currency and for shares of state-owned companies undergoing privatization. The most glaring example involves a businessman close to President Mahmoud Ahmadinejad's chief of staff who was charged with illegally obtaining letters of credit worth $2.8 billion to buy controlling shares in a major steel company.[46] The case, which some call Iran's Watergate, has led to the dismissal of several bank presidents, more than thirty arrests, and the near impeachment of Iran's finance minister.[47]

While many Iranians blame Ahmadinejad's reckless rhetoric and their government's aggressive policies for sanctions imposed since 2006, piling on penalties that affect the

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[40] Slavin, "Iran Sanctions: Preferable to War but No Silver Bullet" (**www.acus.org/files/publication_pdfs/403/060211_ACUS_Slavin_SilverBullet.pdf**).
[41] Cohen testified before Congress, October 13, 2011 (**http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=30888c90-5bff-45f0-8590-b91d6da71b76**).
[42] Khajehpour spoke on September 30, 2011, at the Wilson Center.
[43] Barbara Slavin, "The Ahmadinejad Show," *Foreignpolicy.com*, September 23, 2011 (**www.foreignpolicy.com/articles/2011/09/23/the_ahmadinejad_show?page=full**).
[44] Khajehpour at the Wilson Center.
[45] Khajehpour at NIAC conference on sanctions, October 4, 2011.
[46] Slavin, "The Ahmadinejad Show."
[47] Rick Gladstone, "New Arrests and Interrogations in Iran Fraud Case," *New York Times*, Oct. 25, 2011 (**www.nytimes.com/2011/10/26/world/middleeast/new-arrests-and-interrogations-in-iran-fraud-case.html?_r=1&ref=world**).

general population could have a rallying effect. In response to recent calls in the US Congress to sanction Iran's Central Bank, for example, some Iranians have asserted that the US is moving to treat Iran like Saddam Hussein's Iraq as a pretext for invading Iran.[48]

Targeting the Central Bank

Legislation under consideration in the US Congress would require the Obama administration to report the ways in which the Central Bank of Iran (CBI) is being used to circumvent sanctions. This is a step toward sanctioning the bank itself on top of twenty-two Iranian banks already placed on a US blacklist. Mark Dubowitz, director of the Iran Energy Project at the Foundation for Defense of Democracies, said barring dealings with the CBI is necessary to "perfect CISADA," because "the CBI has become the default bank of choice for Iranians . . . The CBI is being used both to circumvent financial sanctions and to support proliferation and dual use trade."[49] Other provisions being considered would declare the United States an "Iranian oil-free zone" by barring imports of products, including gasoline, that contain any Iranian crude. The goal of both measures, Dubowitz said, is to worsen the terms of trade for Iran so that "the Chinese, the Turks and whoever is engaging in trade will be able to demand significant discounts. You want to go after the sale of Iranian oil in a way that doesn't spook oil markets and drive up the price."[50]

The Obama administration has yet to take a position on new legislation, although Cohen, in his recent testimony, said, "We are looking very actively at the prospect of sanctioning the CBI." He sounded less enthusiastic about the "oil-free zone" idea. "The economics . . . are complicated," he said, and could cause "collateral ill effects" on the US and global economy.[51]

Opponents of such measures warn that they will cause oil prices to rise at a time of extreme fragility in the global economy—thus inadvertently helping Iran. They say this would also hurt ordinary Iranians and members of the Iranian diaspora who are already having difficulty carrying out benign financial transactions through an ever-shrinking number of approved Iranian banks. Kevan Harris, a sociologist at Johns Hopkins University who studies the Iranian economy, warned that new sanctions could backfire if a desperate Iran decides to punish the world by suddenly withdrawing its oil from the market. "You have to be careful what you wish for," Harris said. "You are really playing a dangerous game."[52]

There is also the possibility that sanctioning the CBI will fracture the international consensus against Iran that the Obama administration has been so successful in building.[53] Chinese, Indian, and even European officials have made it clear that they do not intend to follow the US lead. "Closing down the CBI would make things difficult for Iranian exiles and drive up oil prices," said the European diplomat in Washington cited earlier. "I'm not sure even Congress wants to do this in an election year."[54] Most foreign governments would also reject an oil embargo, even though that is the one penalty that could actually "cripple" the Iranian economy.

"In general, the United Nations and most countries are not as willing as the United States to sanction oil trade directly," said Kimberly Elliott, a specialist on sanctions at the Center for Global Development. "That is a big loophole, but closing it by trying to coerce our allies into cooperating would have high costs as well, especially with Europe teetering on the edge of financial crisis."[55]

A US official, speaking on condition he not be named, said the Obama administration was well aware of the possible economic and diplomatic blowback of further sanctions. "The reality is, there is always some [political] attachment to big sanctions measures. We have to be sure when we take such measures that we don't end up hurting ourselves," he said. Asked about the "oil-free zone" proposal, the official

48 Yasaman Baji, "Plot Allegations Stir Complex Nationalist Feelings in Iran," Inter Press Service, October 24, 2011 (**www.ipsnews.net/news.asp?idnews=105585**).
49 Interview with the author, October 13, 2011.
50 Ibid.
51 Cohen's testimony before Congress, October 13, 2011 (**http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_id=a3a0c72e-4250-49ba-8c8b-b2cae715a75a**).
52 Barbara Slavin, "New Iran Sanctions Could Bring Unintended Blowback," Inter Press Service, August 11, 2011 (**http://ipsnews.net/news.asp?idnews=56828**).
53 Sanctioning the Central Bank would adversely impact projects such as the Shah Deniz consortium, led by British Petroleum, to exploit Azerbaijan's largest gas field and bring the energy to Europe as it involves a small passive Iranian investment.
54 Interview with the author, October 21, 2011.
55 Interview with the author, October 11, 2011.

said, "We're looking at the legal, policy and economic issues associated with that kind of action. While in theory that's possible, it could be very difficult," given that refineries mix crude oil from a number of sources. The official continued, "My focus is on trying to find direct measures with more multilateral support and broad applications."[56]

Smarter Sanctions

In a sense, all sanctions are a little bit dumb in that they are bound to have adverse consequences on the general population of a targeted country. The Iranian government has mixed legitimate and illegitimate trade in ways that make it impossible to penalize institutions without also hurting ordinary Iranians and members of the Iranian diaspora. However, some sanctions are smarter than others; for example, those directly targeting Iran's nuclear program have retarded Iran's acquisition of the materials necessary to build centrifuges.[57] David Albright, president and founder of the Institute for Science and International Security, reported recently that Iran has to feed more uranium into its centrifuges to produce the same amount of enriched uranium because many Iranian centrifuges are becoming less effective over time.[58] While sanctions do not prevent Iran from acquiring enough highly enriched uranium to craft a rudimentary weapon, they do make it harder to amass sufficient quantities of fissile material to make a nuclear breakout—with all the attendant diplomatic and economic fallout for Iran—worth doing.

To dissuade Iran from developing nuclear weapons with the least possible collateral damage, the United States and its allies should:

- tighten implementation of existing sanctions that target nuclear proliferation, lobbying UN members—in particular, China—to improve enforcement of Security Council resolutions that forbid selling Iran sensitive materials and permit interdiction of suspicious shipments to Iran;
- provide Iran with a clearer sense of what the international community would accept in terms of uranium enrichment and civilian nuclear activity if Iran clarifies its past behavior and accepts stringent safeguards against diversion of the program to weapons;
- add more sanctions on egregious human rights abusers, which are targeted against individuals and popular with the Iranian people;
- avoid sweeping penalties that could upset world oil and financial markets and fracture the international consensus against a nuclear weapons–armed Iran; and
- reduce US dependence on fossil fuels and encourage other major economies to do so as well.

Conclusion

Sanctions and Asia's economic miracle have altered Iranian trading patterns in ways that have hurt the Iranian economy but not convinced Iran to suspend its nuclear program. Increasingly isolated from the international banking system, Iran has turned to barter with major customers such as China to keep its economy functioning.

As long as global demand for oil and natural gas remains high, Iran will find a way to continue to sell its petroleum products to China, India, and Turkey, as well as to European countries, Japan, and South Korea. There are limits on how ready even US allies will be to embrace more US-imposed sanctions against Iran, especially sweeping measures that are seen as punishing the Iranian people and contributing to higher oil prices.

The United States has been remarkably successful in mobilizing international opinion against Iran's nuclear program, its support for terrorism, and its abuse of human rights. For the time being, the US should focus on better implementation of measures already in place to bolster that coalition, rather than enacting new sanctions that could fracture the global consensus on Iran.

Finally, the Obama administration should put more energy into pursuing a diplomatic solution to the Iranian nuclear conundrum, which would intensify pressure on the Iranian government with the least adverse consequences for the global economy and the Iranian people.

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[56] Interview with the author, October 13, 2011.

[57] Slavin, "How Reliable Is Intelligence on Iran's Nuclear Program?" September 2011 (**www.acus.org/files/publication_pdfs/403/091511_ACUS_IranNuclear.PDF**).

[58] David Albright and Christina Walrond, "Performance of the IR-1 Centrifuge at Natanz," Institute for Science and International Security, October 18, 2011 (**http://isis-online.org/isis-reports/detail/test1/8**).

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