

A REPORT OF THE
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U.S. and Iranian Strategic Competition:

The Sanctions game: Energy, Arms Control, and Regime Change

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EXECUTIVE SUMMARY

This report analyzes US and Iranian strategic competition in four key areas—sanctions, energy, arms control, and regime change. It shows that shifts in the nature and intensity of sanctions on Iran have radically changed this aspect of US and Iranian competition since the Fall of 2011.

This escalation has been spurred by Iran's ongoing missile deployments and nuclear programs, as reported in sources like the November 2011 IAEA report highlighting the probable military dimensions of Iran's nuclear program. It has also been spurred by incidents like an Iranian assassination plot against the Saudi Ambassador to the US, an Iranian-government-sponsored mob attack on the British Embassy in Tehran on November 30, 2011, and Iranian threats to "close" the Gulf to oil exports.

A New Round of Sanctions

Iran's steady progress towards the capability to build nuclear weapons has led to a new round of sanctions from the US and its allies. Washington has sought to further isolate Iran economically through new US sanctions on the Iranian Central Bank and Iranian companies involved in its nuclear industry, including the petrochemical and oil industry. Iran's primary source of revenue—crude oil exports—is further threatened by a unanimous decision by the European Union on January 23rd to impose a full embargo on the import of Iranian oil and petrochemicals.

US and European actions since the latter half of 2011 have supported this strategy by steadily ratcheting up the pressure on Iran.

- March 2012, the U.S. Senate and House of Representatives continue to work on bills that would seek to blacklist essentially every Iranian bank, threaten penalties against European and other overseas companies that deal with any of these banks, and to target communications, software and technology companies that continue doing business with Iranian banks. This legislation would now interact with the EU action on SWIFT, and affect all Iranian institutions and any foreign institution that acted a front or cover for Iran. Members of Congress state that while the U.S. Treasury has already blacklisted 23 Iranian banks, Iran is using more than 20 other banks to finance its nuclear program and support for regional militant groups.¹
- On March 15, 2012, the Society for Worldwide Interbank Financial Telecommunication, or Swift, complied with European Union sanctions on Iranian banks, and EU instructions to, "discontinue its communications services to Iranian financial institutions that are subject to European sanctions." SWIFT is essential to international banking because it provide a secure communications network to more than 10,000 financial institutions and corporations in 210 countries, and SWIFT reported in 2010 that 19 Iranian member banks and 25 financial institutions used the network over 2 million times during the course of the year.²
- In March 2012, as reports of Iran's deepening economic conditions emerged, the government in Tehran came under increased economic pressure from the US Congress. On March 8, the House Foreign Affairs Committee reinforced earlier legislation by introducing with H.R. 4179, "The Iran Financial Sanctions Improvement Act of 2012", expanding sanctions to cover other energy-related commerce. Concurrently,

¹ Laurence Norman and Jay Soloman, "EU-US Split on Iran Banks Seen as Widening," Wall Street Journal, March 16, 2012.

² Rick Gladstone and Stephen Castle, "Global Network Expels as Many as 30 of Iran's Banks in Move to Isolate Its Economy," New York Times, March 16, 2012, http://www.nytimes.com/2012/03/16/world/middleeast/crucial-communication-network-expelling-iranian-banks.html?_r=1; Thomas Endbrink and Joby Warrick, "Grim Outlook on Nuclear Talks," Washington Post, March 16, 2012, p. A7.

the same committee introduced H.R. 4173, designed to “direct the President to appoint a high-level United States Representative or special envoy for Iran” for the purposes of pursuing diplomatic means “to prevent Iran from acquiring a nuclear weapon”.³

- On February 2, 2012, the US Senate Banking Committee unanimously approved a new set of sanctions on Iran “targeting the global financial telecommunications network that nearly all banks depend on to conduct their daily business”. If the Senate Banking bill becomes law, it would direct the White House to demand the Society for Worldwide Interbank Financial Telecommunication (SWIFT) to eject Iran’s central bank, shutting Iran out of the system used to move money between banks worldwide, denying Iran from billions of dollars routed through the SWIFT banking system.⁴
- Additionally, at the end of February 2012, the U.S. Department of Treasury strengthened the preexisting Iranian Financial Sanctions Regulations (IFSR) with the implementation of subsection 1245(d). The amendment moves to extend punishment against “foreign financial institutions that knowingly conduct or facilitate certain significant financial transactions with the Central Bank of Iran (CBI) or a U.S.-designated Iranian financial institution”. In accordance with these actions, the Secretary of Treasury will impose sanctions on privately-owned foreign institutions, as well as government-owned or controlled financial institutions that conduct business with the Central Bank of Iran.⁵
- On February 6, 2012, the Obama administration followed suit as the President issued an Executive Order freezing the assets of the Iranian government and all Iranian financial institutions in the U.S. from being “transferred, paid, exported, withdrawn, or otherwise dealt with”.⁶
- In January 2012, the European Union, which accounts for roughly one-fifth of Iran’s oil exports, introduced new sanctions to be phased in over the course of the year in order to protect European counties with greatest reliance on Iranian oil. The EU embargo prohibits the purchase, transport, and import of Iranian crude oil, the export of major equipment and technology used by the oil sector, as well as related financial deals including insurance. European contracts already existing are allowed to continue until July 1, 2012. Additionally, the EU froze the assets of the Iran’s Central Bank in Europe, and banned the trade of gold and other materials between Europe and the Iranian Central Bank.⁷
- In December 2011 the U.S. House of Representatives passed H.R. 1905, the “Iran Threat Reduction Act”, strengthening US sanctions on the government in Tehran. Despite a December 1 letter to Congress from Treasury Secretary Timothy Geithner expressing the administration’s need for flexibility in its approach towards Iran, the bill easily passed through the House with overwhelming bipartisan support.
- In November 2011, the US Treasury Department rolled out a new round of unilateral sanctions under the auspices of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA). These new sanctions targeted Iran’s petrochemical industry, Central Bank and financial sector, transportation infrastructure, and added dozens of names to the list of sanctioned individuals. These restrictions bar institutions in those countries from having a business relationship with any Iranian banks—including its Central Bank and its affiliates—as well as expanding the sanctions on Iranian individuals and placing new restrictions on the import of Iranian goods.
- On November 21, 2011, the US Treasury Department designated Iran’s entire financial sector, including

³ Text of House of Representative bills H.R. 4173 and H.R. 4179, from the Second Session of the 112th U.S. Congress, introduced on March 8, 2012.

⁴ “Senate Panel Approves Potentially Toughest Penalty Yet Against Iran’s Wallet”, Rick Gladstone, The New York Times, February 2, 2012.

⁵ U.S. Department of the Treasury, “Factsheet: Treasury Amends Iranian Financial Sanctions Regulations to Implement the National Defense Authorization Act”, February 27, 2012.

⁶ “Executive Order—Blocking Property of the Government of Iran and Iranian Financial Institutions”, The White House, Office of the Press Secretary, February 6, 2012.

⁷ “EU Iran sanctions: Ministers adopt Iran oil imports ban”, BBC News, January 23, 2012.

the Central Bank (and all Iranian banks) as “money laundering entities” for Iran-related transactions under Section 311 of the USA Patriot Act. On December 31, 2012, President Obama signed a FY2012 national defense authorization bill (S.1867) that contained an amendment that required the President to prevent a foreign bank from opening and account in the United States if that bank processed payments for oil through Iran’s Central Bank. Section 1245 of the act imposed these unilateral sanctions on the Central Bank of Iran in ways that impose major penalties against entities — including corporations and foreign central banks — which engage in transactions with the Iranian central bank.

- The sanctions on transactions unrelated to petroleum were to come into force 60 days after the bill was and sanctions on transactions related to petroleum were take effect a minimum of 180 days after the bill's signing. The amendment provided for a renewable waiver of 120 days duration if the President determined that doing so is in the national interest. On December 1, 2011, the amendment passed 100-0. These initiatives reflected the impact of a letter sent to president Obama signed by 92 Senators on an August 9, 2011 that called for “a comprehensive strategy to pressure Iran’s financial system by imposing sanctions” on the Central Bank of Iran.⁸ In March 2012, Turkey, Japan and ten European states indicated that they would take steps to decrease their oil imports from Iran. As a result, the US exonerated Japan and the European states from the sanctions. It is still unclear whether the Turkish reduction will gain that country similar status.
- The US Department of State launched a “virtual embassy” for Iran in December 2011. This consisted of a website which was quickly blocked by Tehran amidst allegations that the US was attempting to recruit spies and foster internal regime change. US State department officials claimed that the site was merely an attempt to communicate to Iranians about their ability to secure student visas and explain US policy. It appears that the effort was aimed at weakening support for the regime among young, technically savvy Iranians. This was one of a series of US attempts to make pro-American media and resources available to populations inside Iran.
- The European Union announced tighter sanctions in December 2011, on groups and individuals associated with the Iranian nuclear program. Key foreign ministers made it known that they were drafting and negotiating language that would reduce or completely bar importation of Iranian crude by EU member states. France and Britain pushed for a complete embargo, and the EU overcame hesitation over the possible impact such action would have on the global oil market at a meeting in mid-January 2012 when the most vulnerable governments got assurances that sufficient spare capacity existed in Saudi Arabia and elsewhere to make up for the loss of Iranian oil without causing price shocks. EU officials announced a unanimous decision at their January 23, 2012 ministerial meeting that they would implement a full import embargo on Iranian oil and petrochemicals.
- The US has put pressure on the international banking system that could potentially prevent Iran from using the Society for Worldwide Interbank Financial Telecommunication (“SWIFT”) which operates a worldwide financial messaging network which exchanges messages between banks and other financial institutions and makes secure financial transactions possible. At the same time, members of the US Congress have proposed new sanctions that could affect every international banking transaction with Iran, international insurance coverage with Iran, and all transitions with Iran’s state-owned oil company and its main tanker fleet. In April 2012, President Obama signed an executive order that allowed for the financial sanctioning and banning of travel to the US of Syrian and Iranian parties that track citizens to facilitate human rights abuses. Parties with interests in the US that support such tracking are also covered by the sanctions. Amongst the targeted organizations in Iran are the intelligence and law enforcement communities, the IRGC, and an internet provider. It is reported that the US is considering sanctions against parties outside of Syria and Iran that supply the governments with technology.

⁸ For a more complete history, and discussion in detail of US sanctions legislation and Congressional options for the further strengthening of sanctions, see Kenneth Katzman, Iran sanctions, Congressional Research Service, Washington, DC, RS 20871, December 2, 2011.

The Obama White House is steadily escalating this aspect of US and Iranian competition, but it is doing so carefully and in ways that focus on international action rather than unilateral US action. More forceful sanctions will be pursued gradually and in ways that maximize multilateral buy-in. The Iranian financial, oil, transport, and petrochemical system will be increasingly isolated, to the extent possible. And the Administration will attempt to inform and empower population centers within Iran through channels such as the State Departments “Virtual Embassy” program, in hopes that an opposition movement will again foment and rise to challenge the regime, as external financial constraints, and domestic mismanagement continue to cause economic stagnation.

In accordance with the Obama administration statements that “all options are on the table” in its policy towards Iran, recent statements by top US officials seek to communicate in clear terms the costs Tehran faces for continued obstinate and uncooperative behavior. On March 7 Defense Secretary Leon Panetta told the National Journal that the Pentagon is preparing an “array of military options for striking Iran if hard-hitting diplomatic and economic sanctions fail to persuade Tehran to drop its nuclear ambitions”.⁹ This comes despite earlier statements by Secretary Panetta doubting the effectiveness of a military strike. Just last month, Panetta acknowledged that “at best,” a military strike might set back Iran’s nuclear program “by one, possibly two years”.¹⁰

The Impact of Sanctions and the Iranian Reaction

While the effects of the US and EU sanctions put in force in late 2011 and early 2012 will not become fully apparent until mid-2012 at the earliest, they are already reducing Iranian energy exports and revenues, and creating serious banking and trade problems for Iran. The Iranian Rial has become destabilized, and fell to record lows in January as currency markets reacted to the prospect of more limited foreign trade. The Iranian government, the Iranian economy, and the Iranian people are feeling the pressure.

The Iranian reaction has been mixed, although it is worth mentioning that any admission of internal hardship by Tehran’s government is rare and notable:

- Most remarkably, Iran’s Supreme Leader Ayatollah Khamenei stated in March 2012 that “[t]his is good talk and shows and exit from delusion,” of President Obama’s apparent preference of a diplomatic rather than military resolution to the conflict with Iran. However even Khamenei’s rare conciliatory statement was followed with “But the U.S. president continued saying that he wants to make the Iranian people kneel through sanctions. This part of this speech shows the continuation of illusion in this issue.”¹¹
- As mentioned above, Iranian President Mahmoud Ahmadinejad recently said before Parliament that the current sanctions regime was “the heaviest economic onslaught on a nation in history”.
- On January 24, 2012, Mohsen Qamsari of the National Iranian Oil Company declared to Mehr News Agency that, “Iran can readily find new customers for its oil. We have no problem in selling oil.”
- However, two days prior, on January 26, the former Iranian Oil Ministry deputy, Mehdi Hosseini, admitted that, “Losing the European oil market will have an impact on Iran’s economy which needs rational

⁹ “Panetta: Pentagon Planning for Potential Strikes”, Yochi Dreazan, The National Journal, March 8, 2012.

¹⁰ “U.S. intelligence chief sees limited benefit in an attack on Iran”, Ken Dilanian, The Los Angeles Times, February 16, 2012.

¹¹ “Iran's Ayatollah Khamenei Gives Rare — If Brief — Praise For U.S.”, Eyder Peralta, NPR, March 8, 2012.

planning by the authorities. Selling oil at sub-market level prices is not a good way to counter the oil embargo.”

- On February 19, 2012, Iran’s government responded to European Union sanctions by ordering a halt of oil exports to Britain and France. Earlier, the EU had moved to cut off Iranian oil imports and freeze Iranian central bank assets by July 2012.
- On February 17, 2012, Iran’s senior nuclear negotiator, Saeed Jalili, declared his country’s “readiness for dialogue” at “the earliest possibility”.
- On the one hand Iran’s Foreign Minister called for renewed nuclear talks with the West in January 2012-- although, given Iran’s history, the move may be little more than a stalling tactic for the Islamic regime. This new call for diplomatic engagement seems likely to be just another bid to buy time, and is a indicative of past of the US-Iranian Strategic relationship.
- On the other hand, Iran has issued serious threats to “close the Gulf” and has carried out missile tests and military maneuvers. Iran’s threats and exercises have also been followed by the announcement that it is creating a new, far better sheltered underground uranium enrichment facility and is deploying much more efficient centrifuges.

Iran has made some frank admissions that sanctions are having a major impact. In a rare declaration by a top Iranian official, President Ahmadinejad declared before Iran’s parliament in late 2011 that the current sanctions against Iran were “the heaviest economic onslaught on a nation in history,” adding “every day, all our banking and trade activities and our agreements are being monitored and blocked.”¹²

Given the growing tension between President Ahmadinejad and Ayatollah Khamenei, these statements should not be taken at face value. An increasingly marginalized President may be willing to criticize a leadership he sees as political rivals. Still, Iran’s economic woes cannot be written off as partisan wrangling between the country’s conservative and more conservative camps. As just one indicator, Iran’s currency, long held artificially high by a regime that could afford to subsidize it, has nose-dived and lost 35 percent of its value between September 2011 and early January 2012.¹³

Implications for US Policy

As Chapters III and IV have discussed, the US must be ready for contingencies that could trigger a significant clash or conflict in the Gulf, Israeli preventive strikes, and even serious US military action that escalate to the point where the US might have to strike at Iran’s overall base of asymmetric forces, conventional forces, or nuclear and missile forces. While the US should pursue sanctions and diplomatic options, it must also begin to make hard longer-term choices regarding the possibility that sanctions and diplomacy fail.

This means choosing between containment and preventive strikes, and doing so on the basis of the kind of classified analysis of future options that require full access to both intelligence and military planning data. The choice between bad options should always be as objective as possible, and based on the best information and modeling, and many of the key variables are now so highly classified that outside analysis is severely limited.

Key Near-Term Choices

¹² “Iran’s growing state of desperation”, Fareed Zakaria, FareedZakaria.com, January 4, 2012.

¹³ “Iranian currency slides under latest U.S. sanctions”, Thomas Erdbrink, Washington Post, January 2, 2012.

In the near-term, the US needs to do everything it can to ensure that sanctions lead to successful negotiations. This means pursuing the following options:

- *The US should do everything possible to create UN, multilateral, and national sanctions that are as effective as possible.* The time for gradual approaches is over. If there is to be a peaceful outcome to this aspect of US and Iranian competition, it must come before Iran tests a nuclear device or deploys a nuclear weapon. It must come before Israel takes preventive action or the region becomes locked into a nuclear arms race, and Iran creates a technology base so advanced that current IAEA inspection methods cannot guarantee that it is not developing more advanced capabilities to produce fissile material and the other components of a nuclear weapon covertly or under the guides of carefully compartmented research and develop in area like advance centrifuges and weapons design.
- *Make it clear that the US and its allies also offer Iran incentives to halt, and explain sanctions continuously.* Show other countries that the US and the 5+1 offer Iran real incentives to halt nuclear weapons related activities, and explain and justify sanctions in terms that nations in other regions can fully understand. Sanctions are not enough. Iran needs to see that the US and the rest of the 5+1 will offer incentives in terms of enrichment, fuel supplies, a rapid lifting of sanctions, trade, investment, and energy development. If sanctions are the “stick,” the US must act to ensure that there are real and immediate carrots.
- *The US must work closely with its European, Gulf, and Israeli allies.* The US cannot assume its allies will follow or trust it if does not communicate, consult, and treat them as partners. This is an area where it must be transparent enough to convince the world it is not repeating the mistakes it made in going to war in Iraq, that it will not act precipitously, and it will listen as much as it attempts to lead.
- *Make a convincing case to the Iranian people, its allies and the world that Iran is seeking to obtain nuclear weapons and could be a threat to the global economy.* It is not enough to cite the IAEA and keep up diplomatic pressure. Continue to work with the IAEA and key allies like Britain, France, and Germany to show the dangers in Iran’s actions and make the threat it poses fully convincing. Explain how a crisis in the Gulf could threaten all countries – including the developing countries outside the region. Make the case through effective strategic communications and as objectively as possible.
- *Use arms transfer efforts to supplement sanctions.* The US must do everything possible to keep China, Russia, and other nations from transferring advanced arms and military technology to Iran, or any technology and equipment that could aid it in developing nuclear weapons. At the same time, as is outlined in Chapter VI, it must work with its Arab Gulf allies and Turkey to give them as strong a mix of defenses and deterrents as possible, help Israel achieve the kind of security that can reduce the incentive for preventive strikes, and – as is discussed in Chapter VII – do what it can to make Iraq secure and a real security partner.
- *Work with the UN, IAEA, and its allies to update the arms control proposals necessary to ensure that Iran is complying with a meaningful and verifiable agreement.* It will not be enough for Iran to deal with the immediate concerns raised by the IAEA. It must be clear that any negotiation ends in a viable agreement.
- *Avoid aggressive interference in the form of regime change, but support strategic communications by Iranian exiles and encourage internal Iranian movement towards moderation and democracy.* Focus on regime modification in dealing with the nuclear issue and threat in the Gulf, and leave regime change to Iranians.

Arms Control Offers Hope But a WMD Free Zone Offers Little Probability of Success

The US must support arms control in enforcing the NNPT and giving the IAEA the necessary tools and freedom of action as critical policy option. However, a weapons of mass destruction free zone has virtually no chance of being negotiated in a meaningful form for five reasons:

- Iran’s emphasis on its nuclear and missile programs,
- Israel’s need to maintain nuclear and missile forces,

- The lack of any real prospects for a full Arab-Israeli peace,
- Arab missile, chemical and biological weapons programs and growing interests in nuclear programs, and
- The steadily growing difficulty in creating convincing verification and inspection regimes.

The Uncertain Result: Giving Diplomacy Priority While Preserving Security

Sanctions and diplomacy are the best of a bad (or at least highly uncertain) set of options, but it is far from clear that they will stop Iran from moving toward a nuclear weapons capability, or the actual deployment of nuclear forces. The end result could still be successful negotiations with Iran, but it could also be the beginning of years of more intensive confrontation with Iran at every level.

The risks become higher as time goes on, and this aspect of US and Iranian competition turns into a “long game.” So far, Iran has backed away from military confrontation, but it is far less clear what will happen if sanctions result in a prolonged confrontation. Iran has at least as much to lose as any other Gulf state if it halts oil exports and imports through the Gulf. Iran also cannot hope to win any serious conflict with the US and its Gulf allies..

Iran’s increasingly belligerent statements and actions have already affected the price and flow of oil. Oil prices rose around the world on February 20, 2012 when Iranian officials responded to new European sanctions by halting exports to Britain and France. Two days later, the head of the Iran’s armed forces, Mohammad Hejazi hinted preemptive action on Iran’s part, stating, “Our strategy now is that if we feel our enemies want to endanger Iran’s national interests...we will act without waiting for their actions.” In addition to Iran’s regular threats to close the Strait of Hormuz, this most recent behavior has limited impact on global energy prices.

A period of confrontation and sanctions that lasted for several years will mean lasting increase in oil prices and pressure on the world economy. It will also allow Iran time steadily improve its options and tactics for asymmetric attacks and political warfare, and evidence that Iran actually had a nuclear weapon might both lead many nations to abandon sanctions and make the credibility of US, European, and Southern Gulf escalation major conflicts and strikes on Iran less credible.

Iran will have to take risks of its own, and has no inherent advantages in playing the “long game.” Hostile Iranian actions and Iran’s steady movement towards nuclear weapons capability would probably strengthen US, European, and Southern Gulf resolve, and support for sanctions. Iran would pay a steadily higher cumulative cost as a result of the impact of sanctions over time, and popular support for the regime might well erode. Iran cannot be certain it can use low level asymmetric tactics without provoking the US and other states to escalate to much higher levels of conflict, or be certain it can control the course of events and the risk of some incident leading to serious attacks on Iran’s military forces and other assets.

History, however, is scarcely a consistent record of successful deterrence, rational calculations, and intelligent compromises. Rising pressure on Iran can lead it to take risks, and exercise the kind of military options describe in Chapters III and IV. Limited or demonstrative military actions can become serious clashes, and accidents can escalate into war. At the same time, Iran’s progress towards a nuclear weapons capability can lead Israel to carry out preventive strikes, and force the US to choose between “containment” based on a military build up and extended deterrence or the large-scale preventive strikes necessary to ensure Iran does not deploy nuclear weapons.

The end result is that the US, its Southern Gulf allies, Jordan and other friendly Arab states, and Israel may well face years in which the struggle over sanctions, energy exports, and arms control outlined in this analysis remain part of a process of steadily escalating confrontation at many other levels. What many today are describing as a “crisis” may well be an enduring reality that can only be ended by internal regime change in Iran and only be contained by close cooperation between the US, Arab states in the Gulf and elsewhere, along with key allies like Britain and France.

Negotiations that focus on Iran’s nuclear programs will have important limits even if they succeed. Iran is building up its long-range conventionally armed missile forces, it remains a declared chemical weapons power, and it has biological as well as nuclear options. As its recent exercises in the Gulf show, Iran is also steadily building up its capabilities for asymmetric warfare in ways that can threaten and be used to deliver a wide range of attacks. It continues to use its Al Quds force, intelligence services, and diplomats to pose a growing threat to the Arab states and Israel, in addition to seeking an axis of influence that includes Iraq, Syria, and Lebanon.

This means that a continued focus on sanctions and arms control efforts must be supported by the continued development of military capabilities to deter and contain Iran. The US should preserve and enhance its ability to use force against Iran. The US and its allies should make it clear to Iran that if it conducts nuclear tests, is found to be assembling nuclear weapons or begins to deploy a nuclear-armed missile force might justify the preventive use of military force.

The US and its allies should also find ways to warn Iran that any major Iranian effort to “close the Gulf,” or large-scale conventional or asymmetric clash between Iran and either the US or the GCC, could lead to escalating uses of force. Efforts to remove Iran’s nuclear, missile, and key military facilities would then occur in a radically different context and have far more international support.

At the same time, the need to deter and contain Iran while sanctions and negotiations are still an option is very different from giving military options a priority. The real world political and strategic results of replacing sanctions and diplomacy with the use of force are so unpredictable, and the risks are so high, that force must be a last resort relative to both diplomacy and containment. Such risks should only be viewed differently if it becomes clear that show Iran’s regime has reached ideological extremes where it cannot be deterred by missile defenses, the forces in the Gulf, and threats like a US commitment to extended deterrence.

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Introduction

This report analyzes US and Iranian strategic competition in four key areas—sanctions, energy, arms control, and regime change. Shifts in the nature and intensity of sanctions on Iran have radically changed this aspect of US and Iranian competition since the fall of 2011. This escalation has been spurred by Iran’s ongoing missile deployments and nuclear programs, a November 2011 IAEA report highlighting the probable military dimensions of Iran’s nuclear program, an alleged Iranian assassination plot against the Saudi Ambassador on US soil, an Iranian-government-sponsored mob attack on the British Embassy in Tehran on November 30, 2011, and Iranian threats to “close” the Gulf to oil exports.

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- On March 15, 2012, the Society for Worldwide Interbank Financial Telecommunication, or Swift, complied with European Union sanctions on Iranian banks, and EU instructions to, “discontinue its communications services to Iranian financial institutions that are subject to European sanctions.” SWIFT is essential to international banking because it provide a secure communications network to more than 10,000 financial institutions and corporations in 210 countries, and SWIFT reported in 2010 that 19 Iranian member banks and 25 financial institutions used the network over 2 million times during the course of the year.¹⁵ SWIFT operates a worldwide financial messaging network which exchanges messages between banks and other financial institutions and makes secure financial transactions possible. transaction with Iran, international insurance coverage with Iran, and all transitions with Iran’s state-owned oil company and its main tanker fleet.¹⁶

¹⁴ Laurence Norman and Jay Soloman, “EU-US Split on Iran Banks Seen as Widening,” Wall Street Journal, March 16, 2012.

¹⁵ Rick Gladstone and Stephen Castle, “Global Network Expels as Many as 30 of Iran’s Banks in Move to Isolate Its Economy,” New York Times, March 16, 2012, http://www.nytimes.com/2012/03/16/world/middleeast/crucial-communication-network-expelling-iranian-banks.html?_r=1; Thomas Endbrink and Joby Warrick, “Grim Outlook on Nuclear Talks,” Washington Post, March 16, 2012, p. A7.

¹⁶ Indira A.R. Lakshmanan, “Iran Sanctions Bid Targets Oil, Tanker Companies to Cut Exports,” Bloomberg, Feb 6, 2012 2:26 PM ET; Indira A.R. Lakshmanan , Global Insurers Targeted in Latest U.S. Bid to Expand Sanctions on Iran, Bloomberg, Mar 8, 2012 11:10 AM ET; Al Arabiya, U.S. lawmakers take next step on new Iran sanctions on heels of European embargoes, Tuesday, 31 January 2012; <http://english.alarabiya.net/articles/2012/01/31/191608.htm>; AP sources: Congress to seek new sanctions targeting

- On March 8, the House Foreign Affairs Committee reinforced earlier legislation by introducing with H.R. 4179, “The Iran Financial Sanctions Improvement Act of 2012”, expanding sanctions to cover other energy-related commerce. Concurrently, the same committee introduced H.R. 4173, designed to “direct the President to appoint a high-level United States Representative or special envoy for Iran” for the purposes of pursuing diplomatic means “to prevent Iran from acquiring a nuclear weapon”. Other members of the US Congress proposed new sanctions that could affect every international banking
- On February 2, 2012, the US Senate Banking Committee unanimously approved a new set of sanctions on Iran “targeting the global financial telecommunications network that nearly all banks depend on to conduct their daily business”. If the Senate Banking bill becomes law, it would direct the White House to demand the Society for Worldwide Interbank Financial Telecommunication (SWIFT) to eject Iran’s central bank, shutting Iran out of the system used to move money between banks worldwide, denying Iran from billions of dollars routed through the SWIFT banking system.
- Additionally, at the end of February 2012, the U.S. Department of Treasury strengthened the preexisting Iranian Financial Sanctions Regulations (IFSR) with the implementation of subsection 1245(d). The amendment moves to extend punishment against “foreign financial institutions that knowingly conduct or facilitate certain significant financial transactions with the Central Bank of Iran (CBI) or a U.S.-designated Iranian financial institution”. In accordance with these actions, the Secretary of Treasury will impose sanctions on privately owned foreign institutions, as well as government-owned or controlled financial institutions that conduct business with the Central Bank of Iran.¹⁷
- On February 6, 2012, the Obama administration followed suit as the President issued an Executive Order freezing the assets of the Iranian government and all Iranian financial institutions in the U.S. from being “transferred, paid, exported, withdrawn, or otherwise dealt with”.
- In January 2012, the European Union, which accounts for roughly one-fifth of Iran’s oil exports, introduced new sanctions to be phased in over the course of the year in order to protect European countries with greatest reliance on Iranian oil. The EU overcame hesitation over the possible impact such action would have on the global oil market at a meeting in mid January 2012 when the most vulnerable governments got assurances that sufficient spare capacity existed in Saudi Arabia and elsewhere to make up for the loss of Iranian oil without causing price shocks. EU officials announced a unanimous decision at their January 23, 2012 ministerial meeting that they would implement a full import embargo on Iranian oil and petrochemicals. The EU embargo prohibits the purchase, transport, and import of Iranian crude oil, the export of major equipment and technology used by the oil sector, as well as related financial deals including insurance. European contracts already existing are allowed to continue until July 1, 2012. Additionally, the EU froze the assets of the Iran’s Central Bank in Europe, and banned the trade of gold and other materials between Europe and the Iranian Central Bank.
- In December 2011 the U.S. House of Representatives passed H.R. 1905, the “Iran Threat Reduction Act”, strengthening US sanctions on the government in Tehran. Despite a December 1 letter to Congress from Treasury Secretary Timothy Geithner expressing the administration’s need for flexibility in its approach towards Iran, the bill easily passed through the House with overwhelming bipartisan support.

all Iranian banks Associated Press, March 6, 2012, http://www.washingtonpost.com/politics/federal_government/ap-sources-congress-to-see-new-sanctions-targeting-all-iranian-banks/2012/03/06/gIQA1p0XvR_print.html.

¹⁷ For a more complete history, and discussion in detail of US sanctions legislation and Congressional options for the further strengthening of sanctions, see Kenneth Katzman, Iran Sanctions, Congressional Research Service, Washington, DC, RS 20871, December 2, 2011, as well as Mr. Katzman’s February 2012 update.

- The European Union announced tighter sanctions in December 2011, on groups and individuals associated with the Iranian nuclear program. Key foreign ministers made it known that they were drafting and negotiating language that would reduce or completely bar importation of Iranian crude by EU member states. France and Britain pushed for a complete embargo,
- In November 2011, the US Treasury Department rolled out a new round of unilateral sanctions under the auspices of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA). These new sanctions targeted Iran's petrochemical industry, Central Bank and financial sector, transportation infrastructure, and added dozens of names to the list of sanctioned individuals. These restrictions bar institutions in those countries from having a business relationship with any Iranian banks—including its Central Bank and its affiliates—as well as expanding the sanctions on Iranian individuals and placing new restrictions on the import of Iranian goods.
- On November 21, 2011, the US Treasury Department designated Iran's entire financial sector, including the Central Bank (and all Iranian banks) as "money laundering entities" for Iran-related transactions under Section 311 of the USA Patriot Act. On December 31, 2012, President Obama signed a FY2012 national defense authorization bill (S.1867) that contained an amendment that required the President to prevent a foreign bank from opening and account in the United States if that bank processed payments for oil through Iran's Central Bank. Section 1245 of the act imposed these unilateral sanctions on the Central Bank of Iran in ways that impose major penalties against entities — including corporations and foreign central banks — which engage in transactions with the Iranian central bank. The sanctions on transactions unrelated to petroleum were to come into force 60 days after the bill was and sanctions on transactions related to petroleum were to take effect a minimum of 180 days after the bill's signing. The amendment provided for a renewable waiver of 120 days duration if the President determined that doing so is in the national interest. On December 1, 2011, the amendment passed 100-0. These initiatives reflected the impact of a letter sent to president Obama signed by 92 Senators on an August 9, 2011 that called for "a comprehensive strategy to pressure Iran's financial system by imposing sanctions" on the Central Bank of Iran.
- The US Department of State also launched a "virtual embassy" for Iran in December 2011. This consisted of a website which was quickly blocked by Tehran amidst allegations that the US was attempting to recruit spies and foster internal regime change. US State department officials claimed that the site was merely an attempt to communicate to Iranians about their ability to secure student visas and explain US policy. It appears that the effort was aimed at weakening support for the regime among young, technically savvy Iranians. This was one of a series of US attempts to make pro-American media and resources available to populations inside Iran.

A high level State Department official summarized the new US policy on sanctions in December 2011: "Our policy leverages the power of multilateral action and of likeminded countries to pressure Iran to comply with its international obligations, coupled with an offer to engage diplomatically...if Iran is serious about negotiating and addressing our and the world's concerns about its nuclear program."¹⁸

The Obama White House is steadily escalating this aspect of US and Iranian competition, but it is doing it carefully and in ways that focus on international action rather than unilateral US action. A Chapter IV has shown, the series of statements and speeches that the President and White House have made through March 2012 not only reflect the US desire to avoid military action, but show that tighter sanctions will be pursued gradually and in ways that maximize multilateral buy-in. The Iranian financial, oil, transport, and petrochemical system will be increasingly isolated, to the extent possible. The Administration will attempt to inform and empower population centers within Iran, in hopes that they will rise up to challenge the regime as external financial constraints—along with domestic mismanagement—cause economic stagnation.

¹⁸ Wendy Sherman, Statement before the Senate Foreign Relations Committee, 1 December 2011.

While some analysts believe that this new push on sanctions could pave the way for US military action in Iran, statements by both the President and Secretary of Defense Panetta comments indicate that military strikes—while “on the table”—are unlikely to be pursued by the Administration at this time. A range of senior US officials and officers have also said that limited preventive military strikes on Iran would not destroy Iran's nuclear ambitions, but only delay them for several years. As Secretary of Defense Panetta has said, the relevant targets “are very difficult to get at.”

The reactions from Iran in late 2011 and early 2012 indicate that stronger sanctions and diplomacy are putting increasing international pressure on Iran. As the chronology below shows, most of Iran’s leaders still take a mixed stand on the effectiveness of sanctions:¹⁹

- Ayatollah Khamenei’s March 2012 statement provides one such example of the mixed messages typical from Iranian leaders. Responding to President Obama’s stated preference for diplomacy over war, Khamenei said “[t]his is good talk and shows an exit from delusion, But the U.S. president continued saying that he wants to make the Iranian people kneel through sanctions. This part of this speech shows the continuation of illusion in this issue.”
- On February 19, 2012, Iran’s government responded to European Union sanctions by ordering a halt of oil exports to Britain and France. Earlier, the EU had moved to cut off Iranian oil imports and freeze Iranian central bank assets by July 2012.²⁰
- On February 17, 2012, Iran’s senior nuclear negotiator, Saeed Jalili, declared his country’s “readiness for dialogue” at “the earliest possibility”.²¹
- On January 24, 2012, Mohsen Qamsari of the National Iranian Oil Company declared to Mehr News Agency that “Iran can readily find new customers for its oil. We have no problem in selling oil.” However, two days prior, on January 26, the former Iranian Oil Ministry deputy, Mehdi Hosseini, admitted that “Losing the European oil market will have an impact on Iran’s economy which needs rational planning by the authorities. Selling oil at sub-market level prices is not a good way to counter the oil embargo.”
- January 9, 2012: Supreme Leader Khamenei said in a sermon broadcast by state television on that, “The Iranian nation believes in their rulers ... Sanctions imposed on Iran by our enemies will not have any impact on our nation...Sanctions will not change our nation’s determination...The Islamic establishment ... knows firmly what it is doing and has chosen its path and will stay the course...The chain of power of the people consists of two interconnected factors: first is the definitive decision of the Islamic Republic regime not to deviate from its path and resistance in face of the oppression of superpowers, and secondly, the clever and resolute presence of the loyal people.”²²
- January 1, 2012: IRNA reported that, “President Ahmadinejad stated during an address to the 51st Annual meeting of the Central Bank of Iran that, “The CBI is responsible for balancing the country’s

¹⁹ For an excellent chronology that provides much fuller historical depth, see Varun Vira, Henry A. Ensher, David Pupkin, Stephen Szrom, Maseh Zarif, Daniel Katz, Eiman Behzadi, Kerry Harris, John Karian, *Sanctions on Iran: Reactions and Impact*, AEI, November 1, 2011, <http://www.irantracker.org/us-policy/sanctions-iran-reactions-and-impact>. Two of the October entries in the above list are taken from this report.

²⁰ <http://www.nytimes.com/2012/02/20/world/middleeast/iran-halts-oil-shipments-to-britain-and-france.html?scp=1&sq=iran%20sanctions&st=cse>

²¹ <http://www.nytimes.com/2012/02/18/world/middleeast/swift-network-moves-closer-to-expulsion-of-iran.html?scp=10&sq=iran%20sanctions&st=cse>.

²² Reuters – Mon, Jan 9, 2012, <http://news.yahoo.com/khamenei-says-iran-not-yield-sanctions-112703921.html>; <http://dagobertobellucci.wordpress.com/2012/01/09/islamic-republic-of-iran-sayyed-khamenei-iran-lives-victory-sanctions-on-iran-to-fail/>.

monetary and financial market and it should try to promote justice and national income in the society." Pointing to the enemies' various plots to put pressure on the Iranian nation, Ahmadinejad said the CBI is the backbone of the country in facing enemy pressures and it should be so powerful, self-confident and firm in thwarting enemy plans. Concluding his remarks, Ahmadinejad said there is no special economic problem in the country and the economic indices have improved compared to the past.²³ As mentioned above, Iranian President Mahmoud Ahmadinejad recently said before Parliament that the current sanctions regime was "the heaviest economic onslaught on a nation in history," adding "every day, all our banking and trade activities and our agreements are being monitored and blocked."

- October 29, 2010: National Iranian Oil Company deputy, Mohsen Qamsari, said Iran "reached new agreements for receiving money for Iran's oil exports" and that "Iran's central bank has different and diversified ways and methods for receiving its money from selling oil to India...at the moment there is no Indian accumulated oil debt to Iran." An Iranian state media outlet claimed Indian firms are making payments for oil imports through Russia's Gazprombank. An "Indian industry source" told Reuters there have only been discussions about opening Indian accounts with Gazprombank, and that India continues to make oil payments to Iran through Turkey's Halkbank. India previously paid off a \$5 billion oil debt by submitting payments through Halkbank.²⁴
- October 26, 2010: Iranian Deputy Minister of Economy and Finance Mohammad-Reza Farzin, speaking at the German Council on Foreign Relations, claimed that Iranian imports increased to \$24 billion in six months, \$8 billion of which came from Europe. Farzin predicted that "Iran-East trade" will reach approximately \$140 billion.²⁵
- September 14, 2011: Rafsanjani states in a speech to Iran's assembly of Experts on September 14, 2001 that, "Gentlemen, you should be vigilant and careful. Do not downplay the sanctions ... people should not be tricked...Iran has such a big capacity that it is able to overcome (the sanctions), but I am doubtful that these capacities are being utilized in a proper way, We have never had such intensified sanctions and they are getting more and more intensified every day. Wherever we find a loophole, they (Western powers) block it,"²⁶

Some Iranian officials have responded with their frankest admissions to date that sanctions are having a major impact. Iran has also issued threats to "close the Gulf" and carried out missile tests and military maneuvers. Yet, it has called for a new round of negotiations and claimed that the US and President Obama had called for such talks. The end result can be successful negotiations, the beginning of years of more intense US and Iranian confrontation at every level, or a crisis that leads to armed clashes or serious conflict.

The end result is that the Iranian regime fluctuates between admissions of the effect of sanctions, calling for negotiations, threats to close the Gulf, and carrying out military exercises while boasting about Iran's capability to deter and retaliate. While the full effect of new sanctions will not become apparent until late 2012 at the earliest, they are already causing economic instability by significantly cutting into revenue from Iranian energy exports, as well as creating serious banking and trade problems.

²³ IRNA, <http://www.irna.ir/ENNewsShow.aspx?NID=30743969> November 1: Iranian President Ahmadinejad said "our banks cannot make international transactions anymore" in a speech before the Iranian parliament. [5]

²⁴ Iran Downplays Report India Paying for Oil via Russia," Reuters, October 29, 2011, <http://www.reuters.com/article/2011/10/29/iran-india-oil-idUSL5E7LT06U20111029>

²⁵ Top Iranian Economic Official Highlights Futile Western Sanctions," Iranian Student News Agency, October 26, 2011, <http://www.irna.ir/ENNewsShow.aspx?NID=30632263>

²⁶ Reuters, Tehran, September 14, 2011 11:00am EDT

May 17: Foreign Ministry spokesman Ramin Mehmanparast denied a U.N. report that Iran and North Korea frequently exchanged ballistic missile technology, saying "our scientific and technological capabilities are high enough so that we do not need any other country to give us such technology."

Further, as Iran continues to be seen as an unreliable supplier by energy consumers, it is losing buyers and scrambling to find markets for its crude oil. The Iranian Rial has destabilized and fell to record lows in January as currency markets reacted to the prospect of more limited foreign trade. While Iran's Rial was trading at about 10,500 rials to one U.S. dollar as recently as December 2010, the exchange rate slid to 16,800 rials to a dollar at its low in January 2012. Iran's government, economy, and citizens are feeling the effects of intense sanctions, and indications point to ever worsening economic conditions.

The end result can be Iranian negotiations, the beginning of years of more intense US and Iranian confrontation at every level, or a crisis that leads to armed clashes or serious conflict. On the one hand, Iran's threats and exercises have been followed by the announcement that it is creating a new, far better sheltered underground uranium enrichment facility and deploying much more efficient centrifuges. On the other hand, Iran's Foreign Minister called for renewed nuclear talks in January. Unfortunately, this call for negotiations – and Iran's claim that it was the US and President Obama who had pressed for them – may be an all too familiar gambit to buy time.

Setting the Stage: The Impact of Iran's Dependence on Petroleum Exports and Iran's Vulnerability

In order to understand the pressures Iran faces from sanctions, it is necessary to understand just how dependent Iran is on petroleum and gas exports. Regardless of what Iranian officials may say, Iran is highly dependent on petroleum exports for both its economy and government revenues, and is highly vulnerable to both sanctions and military attacks or embargoes on key facilities. Iran's economy has been weakened by the Iran-Iraq War, sanctions, years of mismanagement and badly structured state intervention, and endemic corruption.

As **Figure V.1** shows, Iran has massive oil and gas reserves, although it has politicized its estimates ever since the Iran-Iraq War in order to increase its relative importance. For example, the EIA reports that the, "*Oil & Gas Journal*, as of January 2011, Iran has an estimated 137 billion barrels of proven oil reserves, 9.3 percent of the world's total reserves and over 12 percent of OPEC reserves. In July 2011, OPEC released its 2010 Annual Statistical Bulletin that raised Iran's proven reserves to more than 151 billion barrels of crude. Some analysts are skeptical of this estimate, however, as Iran revised its reserves a week after Iraq had revised its own, leading some to speculate the move was political."

The EIA also reports that, "Iran has the world's second largest natural gas reserves but the sector is under-developed and used mostly to meet domestic demand. Natural gas accounts for 54 percent of Iran's total domestic energy consumption. Most of the remainder of energy consumption is attributable to oil, with marginal contributions from coal and hydropower. Iran is expected to increase natural gas production from its offshore South Pars natural gas field in the Persian Gulf, an integral component of energy sector expansion plans.

The location of these reserves, Iran's pipelines and export facilities, and key potential targets in Iran's petroleum system are shown in **Figure V.2**.

Massive oil and gas reserves do not translate into national wealth unless they are produced and sold. Iran only had a per capita income that the CIA estimated at around \$12,200 even before the US and Europe imposed new and far more Draconian sanctions in late 2011 and early 2012. Iran's per capita income ranked 84th in the world and was by far the lowest rank of any major oil producer in the Gulf. Iran also had an unemployment level in excess of 15%, and youth

unemployment somewhere between 20-30% -- when acute underemployment was taken into account. Some 18.7% of the population was below the poverty line, and Iran's middle class and business class had already suffered from years of inflation, state intervention, and government corruption.²⁷

The US Energy Information agency estimates that Iran received some \$73 billion in petroleum export revenues in 2010, and \$959 in per capita revenues – roughly one twelfth of the entire per capita income.²⁸ Oil revenues were Iran's only major source of hard currency, and the CIA estimates that they account for 80% of all Iranian exports in 2011, or some \$78 billion out of a total of \$131.8 billion in annual exports. Their value was roughly equivalent to the nation's entire total for imports in 2011 (\$76.1 billion.). The Iranian economy could not function without them, and is sufficiently marginal so every dollar equivalent matters – particularly since Iran's reserves only totaled some \$109.7 billion at the end of December 2011.²⁹

Sanctions and Oil Production Capacity

Sanctions and embargoes can affect two major aspects of Iran's energy income: its ability to develop its reserves and maintain or increase its export capacity, and its actual exports. Experts disagree over both the impact of sanctions to date, and Iran's broader problems in maintaining and increasing its production capacity. Iran naturally denies such problems and advocates of sanctions tend to make exaggerated claims. The US Energy Information Agency seems to be relatively neutral, and it makes public analyses that seem to track broadly with in house OPEC and IEA studies.

In the case of oil, EIA reporting in February 2012 noted that,³⁰

... As per the Iran Transactions Regulations, administered by the U.S. Department of Treasury's [Office of Foreign Assets Control](#) (OFAC), U.S. persons may not directly or indirectly trade, finance, or facilitate any goods, services or technology going to or from Iran, including goods, services or technology that would benefit the Iranian oil industry. U.S. persons are also prohibited from entering into or approving any contract that includes the supervision, management or financing of the development of petroleum resources located in Iran. See [OFAC's Iran Transactions Regulations](#) page for more information.

The state-owned National Iranian Oil Company (NIOC), under the supervision of the Ministry of Petroleum, is responsible for all upstream oil projects, encompassing both production and export infrastructure. The National Iranian South Oil Company (NISOC), a subsidiary of NIOC, accounts for 80 percent of oil production covering the provinces of Khuzestan, Bushehr, Fars, and Kohkiluyeh and BoyerAhmad. Nominally, NIOC also controls the refining and domestic distribution networks, by way of its subsidiary, the National Iranian Oil Refining and Distribution Company (NIORDC), although functionally there is a separation between the upstream and downstream sectors.

The Iranian constitution prohibits foreign or private ownership of natural resources. The government permits buyback contracts that allow international oil companies (IOCs) to enter into exploration and development contracts through an Iranian affiliate. The contractor receives a remuneration fee, usually an

²⁷ CIA, World Factbook, "Iran," March 8, 2102, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>

²⁸ EIA, OPEC Revenues Factsheet, http://www.eia.gov/cabs/OPEC_Revenues/Factsheet.html.

²⁹ CIA, World Factbook, "Iran," March 8, 2102, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>

³⁰ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

entitlement to oil or gas from the developed operation, leaving the contractor to provide the necessary capital up-front. Once development of a certain field is complete, however, operatorship reverts back to NIOC or the relevant subsidiary

... Since the 1970s, Iran's production has varied greatly. Iran averaged production of over 5.5 million bbl/d of oil in 1976 and 1977, with production topping 6 million bbl/d for much of the period. Since the 1979 revolution, however, a combination of war, limited investment, sanctions, and a high rate of natural decline in Iran's mature oil fields have prevented a return to such production levels.

An estimated 400,000-700,000 bbl/d of crude production is lost annually due to declines in the mature oil fields. To offset natural decline rates, Iran's oil fields require structural upgrades including enhanced oil recovery (EOR) techniques such as natural gas injection, which has put even greater strain on energy supply due to rising demand for natural gas domestically. Iran's reserves are not confined to the southwest and offshore Persian Gulf, creating potential for further discoveries. Iranian has oil reserves under the Caspian Sea, but exploration and development of these reserves have been at a standstill due to territorial disputes with neighboring Azerbaijan and Turkmenistan. Iran also shares a number of both onshore and offshore fields with neighboring countries, including Iraq, Qatar, Kuwait, and Saudi Arabia.

There were a number of new discoveries in Iran over the past couple of years. In May 2011, NIOC announced a discovery of a deposit of light oil (35° API gravity) in the Khayyam field, offshore in the Hormuzgan province. The field had been discovered in 2010 but was originally classified as a gas field. According to the NIOC, the volume of in-place oil at this field is 758 million barrels, of which around 170 million barrels are recoverable. Also in May 2011, Iran announced the discovery of new onshore oil fields in its south and west with an estimated half a billion barrels of reserves. In late 2010, Iran claimed the discovery of new crude finds near gas reservoirs in the Persian Gulf, holding total in-place reserves of more than 40 billion barrels of oil, however recoverable reserves could be less than 10 billion barrels.

There are few upstream oil projects in development, and those that are proceeding have been slowed by the loss of expertise, technology and funding in the wake of various sanctions. The most promising prospects for a boost in production capacity comes from two specific projects: Azadegan and Yadavaran. Other current oil projects include Jofeir, Resalat, and Forouzan, all of which have been significantly delayed due to sanctions.

The Azadegan field was Iran's biggest oil find in 30 years when announced in 1999. It contains 26 billion barrels of proven crude oil reserves, but its geologic complexity makes extraction difficult. The field is separated into two portions: North and South Azadegan. China National Petroleum Corporation (CNPC) is developing North Azadegan in a two-phase development with ultimate total production estimated at 150,000 bbl/d (75,000 bbl/d for each phase). In 2004, a consortium of NIOC (25 percent) and Japan's INPEX (75 percent) signed an agreement for development of the southern portion of the Azadegan field.

In 2006, INPEX lowered its stake to 10 percent and following growing pressure in the wake of sanctions last year; it pulled out of the project completely in October 2010. In September 2009, a subsidiary of CNPC, China National Petroleum Corporation International Limited (CNPCI), signed a memorandum of understanding (MOU) with NIOC to develop South Azadegan in two phases. Yadavaran is the other promising upstream oil development project. China Petroleum & Chemical Corporation (Sinopec) signed a buyback contract at the end of 2007 to develop Yadavaran in two phases. The first will produce at a plateau of 85,000 bbl/d (by 2014), while the second will boost production to 185,000 bbl/d by 2016.

Over the past year, a number of new exploration projects have been undertaken and completed. The completed exploration projects include the Anaran Block, which consists of two large oil fields, Changooleh and Azar (expected to produce 67,000 bbl/d and 68,000 bbl/d, respectively). In addition, exploration projects in the Koohdasht, Garmsar, and Tousan Blocks have been completed, with disappointing results. Some of the exploration projects resulted in no successful gas and/or oil discoveries. Overall, according to FACTS Global Energy (FGE), Iran's discoveries of crude oil and condensates totaled 10.7 billion barrels in 2010.

Iran's development problems have been compounded by the fact that the Iranian National Oil Company and government have done a notoriously bad job of structuring attractive proposals for outside investment and participation in petroleum deals – although they sometimes eventually

compromise on more financially realistic agreements. Investment in Iranian oil and gas does not give the outside country or company control over Iran's reserves, forces it to sell to the highest bidder at world prices, and presents the constant risk of nationalization or unilateral cancellation without compensation. Iran's internal political instability adds to this risk and the end result is that energy investments in other more stable oil exporting countries often offer better terms. Outside powers and companies are also increasingly cautious about dealing with Iran in ways that lead to tensions with the Arab oil and gas exporting states.

Sanctions and Gas Production Capacity

In the case of gas, Iran has some 16% of the world's conventional proven gas reserves. The Energy Information Agency (EIA) of the US Department of Energy (DoE) estimates that Iran has 1,046 TCF vs. 1,680 TCF for Russia, which has the largest conventional reserves in the world and 896 TCF for Qatar, which ranks third in the world.³¹ However, fracturing and other technological reserves are sharply reducing the importance of conventional vs. total reserves, and Iran's percentage of potentially commercial reserves may be closer to 8% than 16%.³² Iran currently only produces 4.3% of world conventional gas, and has limited export capability. In contrast the Arab Gulf states have some 26% of the world's conventional gas reserves and produce some 10% of world gas.³³

The EIA reports that,³⁴

The National Iranian Gas Company (NIGC) is responsible for natural gas infrastructure, transportation, and distribution. The National Iranian Gas Exports Company (NIGEC) was created in 2003 to manage and to supervise all gas pipeline and LNG projects. Until May 2010, NIGEC was under the control of the NIOC, but the Petroleum Ministry transferred NIGEC, incorporating it under NIGC in an attempt to broaden responsibility for new natural gas projects.

Due to the poor investment climate and international political pressure, some international oil companies including Repsol, Shell, and Total have divested from Iran's natural gas sector. In response, Iran has looked toward eastern firms, like state-owned Indian Oil Corp., China's Sinopec, and Russia's Gazprom to take an increased role in Iranian natural gas upstream development. Activity from these sources has also been on the decline due to logistical difficulties experienced as a result of sanctions on technology and financial transactions.

Under Iran's buy-back scheme, foreign firms hand over operations of fields to the National Iranian Oil Company (NIOC), and after development they receive payment from natural gas production to cover their investment. National Iranian South Oil Company (NISOC), a subsidiary of NIOC, is responsible for much of the southern natural gas production.

...Iran's natural gas production has increased by over 550 percent over the past two decades, and the consumption has kept pace. As demand growth rates persist, the potential for shortfalls in natural gas supply grows. Iran's natural gas exports likely will be limited due to rising domestic demand, even with future expansion and production from the massive South Pars project, and other development projects.

In 2010, Iran produced an estimated 6 Tcf of marketed natural gas and consumed an estimated 5.1 Tcf. A sizeable volume of the gross natural gas produced (7.7 Tcf in 2010) was reinjected (1.2 Tcf). As Iran

³¹ Energy Information Agency (EIA) of the US Department of Energy's country report on Iran as of January 2012: <http://www.eia.gov/countries/cab.cfm?fips=IR>

³² Ibid. pp. 21, 22.

³³ Ibid.

³⁴ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

implements its plans for increased crude production through EOR techniques, however, the share of natural gas used for re-injection is expected to increase dramatically.

... The most significant energy development project in Iran is the offshore South Pars field, which produces about 35 percent of total gas produced in Iran. Discovered in 1990, and located 62 miles offshore in the Persian Gulf, South Pars has a 24-phase development scheme spanning 20 years. The entire project is managed by Pars Oil & Gas Company (POGC), a subsidiary of the National Iranian Oil Company. Each phase has a combination of natural gas with condensate and/or natural gas liquids production. Phases 1-10 are online. The majority of South Pars natural gas development will be allocated to the domestic market for consumption and gas re-injection. The remainder will either be exported as liquefied natural gas (LNG) and/or used for gas to liquids (GTL) projects.

Kish, with estimated reserves of 50 Tcf, it is expected to produce 3 Bcf/d of natural gas. Phase I of the project, which experienced repeated delays is expected to come online in 2016. Phase I is expected to produce approximately 1 Bcf/d and Phase II of the project will produce an additional 2 Bcf/d. In addition to Kish, there are other promising gas fields that could further boost Iran's production. However, these projects also are characterized by delays and other difficulties. These additional fields include the Golshan, Ferdowsi, and North Pars gas fields although their start-ups are unlikely to occur until the next decade.

While experts argue the details, this analysis illustrates that Iran has far greater potential to produce and export gas and oil than it has been able to exploit. The degree to which past sanctions affected delays, bid failures, and contract cancellations remains uncertain, but it is clear that sanctions have had a major impact.

More importantly, they also make it clear that the new sanctions that the US and EU are imposing will make things far worse, and that the more Draconian sanctions on all Iranian banking activity being suggested by some members of the US Congress would have even more serious effects. Some powers like China and Russia may be able to ignore such sanction in making oil and gas investments, but Iran's ability to main and expand its production capacity is fragile and the new sanction should hit hard over time.

Sanctions and Iranian Oil Exports

The impact of sanctions on Iran's ability to sell and move its oil and gas exports is far more immediate. As **Figure V.3** shows, Iran has had major cycles of security problems with its oil production and exports ever since the fall of the Shah – a time when Iran's exports peaked at 3 million barrels a day. The EIA reports that Iran exported approximately 2.2 million bbl/d of crude oil in 2010, and that Iranian Heavy Crude Oil was Iran's largest crude export followed by Iranian Light: "In 2010, Iran's net oil export revenues amounted to approximately \$73 billion. Oil exports provided half of Iran's government revenues, while crude oil and its derivatives accounted for nearly 80 percent of Iran's total exports."³⁵

The practical impact of Iran's export potential must be kept in perspective. Iran at most has some 10% of the world's proven oil reserves (137 billion barrels vs. 263 billion for Saudi Arabia, 211 billion for Venezuela, and 175 billion for Canada), and its percentage of potential reserves is substantially lower.³⁶ Iran currently only produces 5.2% of world conventional oil liquids, and has been very slow to increase production.

³⁵ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

³⁶ BP, *BP Statistical Review of World Energy*, June 2011, bp.com/statisticalreview. pp. 6, 8

In contrast the Arab Gulf states have some 72% of the world's conventional oil reserves and produce some 25% of world oil.³⁷ Iran lacks total refinery capacity, and product export capacity, and its large, steadily growing population consumes a significantly larger part of its total production than is the case in the Arab Gulf states. Moreover, Iran has already tapped 75 percent of its known reserves, so the likelihood of new, major discoveries is low. Recently discovered sources have allowed Iran to hold oil production relatively steady, and they may even help production levels to grow somewhat in the immediate future, but new sources will not be able to offset natural declines beyond the short-term (see As a result, Iran will have to rely heavily on proven but undeveloped reserves, which will require major new investments.³⁸

At the same time, the effectiveness of sanctions is partially dependent on the choices made by the importing nation. **Figure V.3** also shows that some countries were far more dependent on Iranian exports than others at the time the US and EU imposed their new sanctions. This is a key reason why some of the new sanctions described later were tailored to give countries time to change their imports, and deal with either different refinery and product needs, or the end of preferential Iranian terms.

At the same time, the same importing states have to carefully consider what happens if they do not comply. As the EIA noted in February 2010,³⁹

Iran's oil exports also have been affected by sanctions. In 2011, Iran experienced significant problems with receiving payments from India for its exports, when the Reserve Bank of India halted a clearing mechanism due to sanctions. Some of the payments have been cleared through Turkish and UAE banks. More recently, NIOC announced that India has cleared all oil debts to Iran through Gazprombank of Russia and Iran has already received all overdue payments for its exports to India.

Iran also faces problems because it has very high domestic consumption of both domestic and imported petroleum products. Subsidized prices and a population that has doubled since the 1979 revolution created excessive demand. Natural gas accounts for half of Iran's total domestic energy consumption, while the remaining half is predominately oil consumption.⁴⁰ A significant portion of what Iran refines is low-value fuel oil, forcing them to rely on imports for higher value-added refined products, such as gasoline, jet fuel and diesel. These energy imports are essential to accommodate the growing public appetite for subsidized fuels, especially gasoline and gas oil.⁴¹

Iran has increased prices to reduce consumption, but still faces problems both in maintaining its volume of exports and because it lacks refinery capacity and has to import product. Past sanctions have already had an impact in limiting Iran's refinery expansion plans, and the new sanctions will have a much stronger impact of Iran's ability to get investment and technology, and to pay for product imports. The EIA notes that,⁴²

³⁷ BP, *BP Statistical Review of World Energy*, June 2011, bp.com/statisticalreview. pp. 6, 8

³⁸ Ibid

³⁹ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

⁴⁰ Ibid

⁴¹ Ibid

⁴² EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

Iranian domestic oil demand is mainly for diesel and gasoline. Total oil consumption was approximately 1.8 million bbl/d in 2010, about 10 percent higher than the year before. Iran has limited refinery capacity for the production of light fuels, and consequently imports a sizeable share of its gasoline supply. Iran's total refinery capacity in January 2011 was about 1.5 million bbl/d, with its nine refineries operated by the National Iranian Oil Refining and Distribution Company (NIORDC), a NIOC subsidiary.

The Iranian government subsidizes the price of refined oil products, however price reforms instituted in December 2010 removed some of the subsidies, which significantly affected gasoline consumption in Iran (see Gasoline section below). Iran is an overall net petroleum products exporter due to large exports of residual fuel oil.

Iran has had other difficulties with refinery capacity expansion recently. During the inauguration ceremony (led by Iran's president Mahmoud Ahmadinejad) of the Abadan refinery expansion, a gasoline unit blew up as a result of a gas leak. It took NIORDC four months to rebuild the unit and bring it online.

Finally, Iran plans to increase refining capacity with the aim to become self-sufficient for gasoline. Plans for capacity increases through expansions at existing refineries as well as planned greenfield refinery construction have been announced. Iran has issued permits to construct six new refineries with a combined refining capacity of 1.2 million bbl/d; however there has been little progress because of financing difficulties.

Sanctions imposed on Iran have made it difficult for the country to import needed volumes of gasoline. The government has attempted to control consumption by implementing accelerated subsidy reform, resulting in a sharp increase in the price of gasoline. The subsidy reform spurred political opposition because of inflationary fears in the midst of an economic downturn. Furthermore, petrochemical plants were converted so that they can produce gasoline as a short-term measure. However, the converted plants produce low quality gasoline, causing significant environmental problems.

In 2010, Iran consumed around 400,000 bbl/d of gasoline, about 4 percent less than consumed in 2009. Iran does not currently have sufficient refining capacity to meet its domestic gasoline and other light fuel needs. However, the government has approved a number of expansions of existing as well as construction of new refineries with the aim to make Iran self-sufficient (and an exporter of gasoline).

Iranian gasoline imports were approximately 78,000 bbl/d in 2010, nearly 70 percent of total product imports. Current and proposed expansions of Iranian refineries likely will come online between 2012 and 2017. Iran is expected to remain a gasoline importer next year, however if proposed expansions occur as planned, it is possible the country will become a gasoline exporter in 2015.

Sanctions and Iranian Gas Exports

Gas exports are far less important to the Iranian economy than oil exports, but the EIA estimates that, "Iran imports natural gas from its northern neighbor Turkmenistan. According to FGE, imports jumped to 1.1 Bcf/d between January and October 2011 as a result of completion of the Dauletabad-Hasheminejad pipeline. Iran has been importing natural gas from Turkmenistan since 1997. Iran exports natural gas to Turkey and Armenia via pipeline. Turkey, an importer since 2001, received 762 MMcf/d in 2010, while exports to Armenia totaled 24 MMcf/d in 2010."⁴³

The main impact of sanctions and US diplomatic pressure to date has been in reducing Iran's capacity to export. The EIA reports that,⁴⁴

⁴³ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

⁴⁴ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

Iran has an extensive natural gas pipeline system, which includes trunk lines, import/export pipelines, and gathering and distribution lines. The backbone of the domestic pipeline system is the Iranian Gas Trunkline (IGAT) pipeline series, which transport natural gas from processing plants to end-use consumers.

Development of IGAT pipelines, fed by South Pars development phases, is important to Iran's natural gas transport. IGAT-8 (2012/2013) will run nearly 650 miles to Iran's northern consumption centers, including Tehran. IGAT-9 and IGAT-10 are still in the planning phase and are not likely to become operational before 2017. Iran exports natural gas via pipeline to Turkey and Armenia. The Iran-Turkey pipeline began exports in 2001 with 34 million cubic feet (MMcf) per day and exports gradually rose to 762 MMcf per day in 2010.

In May 2009, Iran began exports of natural gas to Armenia after a couple of years of delays. Exports to Armenia totaled 24 MMcf per day of gas in 2010 in exchange for electricity. Pipeline exports to Armenia are expected to increase to 224 MMcf per day in 2020.

Future pipeline projects (at various stages of planning) include the Iran-UAE pipeline, Iran-Pakistan pipeline, and Iran-Europe gas export project. Additionally, the governments of Iran and Syria have signed several MOUs to build a pipeline linking the two countries. However, this project is becoming less likely as a result of the unrest in Syria and is predicated upon the survival of the Assad regime.

A controversial pipeline proposal (**Figure V.4**) is the \$7.4-billion Iran-Pakistan-India (IPI) line that would transport Iranian natural gas south to the Asian subcontinent. With a proposed 1,700 miles and a 5.4 Bcf/d capacity, the pipeline has been stalled in the past due in part to disputes over the cost of the shipments. Iran and Pakistan have finalized gas sales and purchase agreements, but without India's participation in the negotiations. It is probable that Iran would extend its domestic Iran Gas Trunkline 7 (IGAT-7) pipeline into Pakistan, avoiding the creation of a new, parallel pipeline.

It again is unclear how much US sanctions and diplomatic efforts have really limited these pipeline developments. Their cost, and the risk of going through Afghanistan and Pakistan is a major deterrent without any other factors. This is less true in the case of Turkey, but Iran also has not always presented viable business terms.

Iran's Energy Targets

While it is not directly related to sanctions, **Figure V.2** highlights the fact that Iran has many highly vulnerable energy targets that are potential hostages to any Iranian effort to "close the Gulf" of the kind described in Chapter III. Iran's main oil export terminals and other ports could easily be mined by air, or be hit surgically with precision guided munitions or cruise missiles.⁴⁵

Iran's main oil terminal is at Kharg Island and is easy to "close" or destroy using mines, cruise missiles, and stand-off air munitions. The EIA reports that Kharg Island has a crude storage capacity of 20.2 million barrels of oil and a loading capacity of 5 million bbl/d, but it is along the upper coast of the Gulf, and any ships or tankers moving in or out could be easily embargoed or attack. Lavan Island is closer to the Strait, but only has the capacity to store 5 million barrels and load 200,000 bbl/d. Other terminals that are potential – but much less important targets -- include Kish Island, Abadan, Bandar Mahshar, and Neka (which helps facilitate imports from the Caspian region).⁴⁶

As **Figure V.5** shows, many of Iran's refineries are near the coast and easy to strike – and present an attractive follow-up target to any Iranian reprisals for a preventive strike. Similarly,

⁴⁵ This target analysis uses the data in EIA, DOE, Country Analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

⁴⁶ EIA, DOE, Country analysis Briefs, "Iran," February 17, 2012, <http://205.254.135.7/countries/cab.cfm?fips=IR>

Iran's internal gas distribution system has no major impact on world oil exports and the global economy, but has many critical points that could cut off gas to key cities and areas in Iran. Such strikes could be combined with strikes on electric facilities to have a major temporary impact on a city like Tehran.

Iran's power grid is another attractive set of targets and one where attacks could be combined with attacks on Iran's domestic gas distribution system. Even though Iran exports electricity to some of its neighbors -- including Iraq -- its power grid is extremely vulnerable, as are many of its generating facilities.⁴⁷ The EIA reports that Iran generated 201.6 billion kilowatt hours (Bkwh) of electricity in 2009, and consumed 161.5 Bkwh. This was generated from a network capacity of 53 gigawatts (GW), which is strained during times of peak demand. Approximately 97 percent of total electricity supply was generated by conventional thermal electric power that inevitably creates highly vulnerable targets and key points in the distribution systems that are equally vulnerable.

Moreover, EIA reports that, "some power plants are running as low as 10 percent of their nameplate capacity as Iran's electricity infrastructure is largely in a state of dilapidation and rolling blackouts become endemic in summer months. The amount of generation lost in distribution is a central indicator of the disrepair of the electricity network, with upwards of 19 percent of total generation lost during transmission...Iran has focused on meeting higher demand by expanding gas-fired combined-cycle and hydroelectric power capacity. Expansion of electric power generation capacity will require significant investment, made much tougher by international sanctions. The government has announced that it has opened the sector to foreign investment, but sales of existing state-owned facilities as well as new independent power projects has been almost non-existent."

It should be stressed in making these points, however, that the fact Iran has many targets, and its lack of modern aircraft and surface-to-air missiles make it highly vulnerable, is scarcely an incentive to carry out such strikes -- particularly if they do lasting damage to key facilities or long-lead-time-for-replacement components. Moreover, it is far easier to talk about precision that avoids civilian casualties, unnecessary collateral damage, and avoids lasting damage, than it is to execute such strikes.

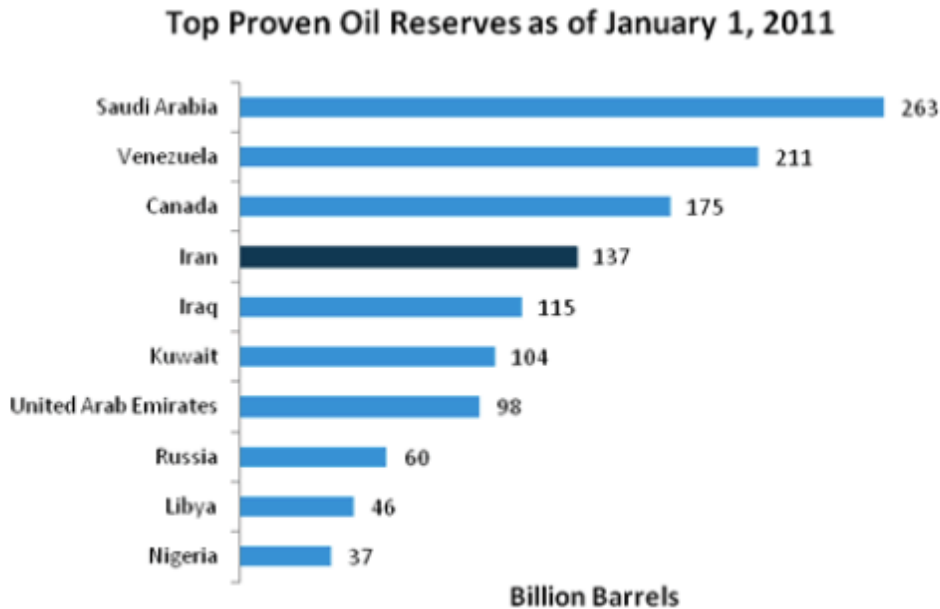
Escalation is always a two-way street, particular if Iran shifts to a long conflict or attrition or reacts by rushing to go nuclear. Cutting Iran's export capability affects the global economy and not just Iran. Moreover, it will be the urban residents of Iran that suffer most from attacks on gas or electric facilities and distribution, and not the government. Like sanctions, the people will suffer before the ruling elite.

The fact remains, however, that no discussion of the vulnerability of the Arab Gulf, or closing the Gulf, should ignore the fact that anything Iran initiates can not only be dealt through counter targeting, but Iran will lose virtually any conflict that involves serious escalation not only in terms of military losses but economic losses as well. This may not deter Iran from either going

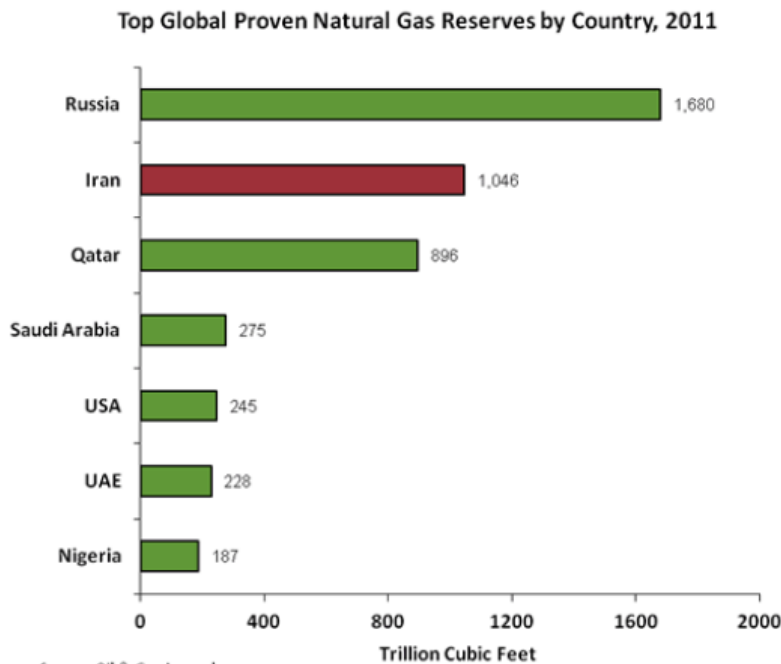
⁴⁷ The EIA reports that Iran is a net exporter of electric power and currently exports electricity to neighboring states including Armenia, Pakistan, Turkey, Iraq, and Afghanistan. Azerbaijan and Armenia supply electricity to Iran. Armenia and Iran will increase the volume of electricity that they deliver to each other on a seasonal basis, according to a November 2011 agreement. Total volume of power swapped between the two countries will rise from 350MW at present to 1,200MW following the completion of construction of a third, 400-kV transmission line connecting Iran and Armenia, expected for mid-2012.

on with its nuclear efforts or from initiating some form of clash or conflict. It is axiomatic, however, than any nation sophisticated enough to produce the capability to fight asymmetric warfare described in Chapters III and IV, has to learn its own vulnerabilities in the process. This may not deter Iran’s leaders but they can scarcely ignore these realities.

Figure V.1: Iran’s Comparative Oil and Gas Reserves



Source: Oil and Gas Journal



Source: Oil & Gas Journal

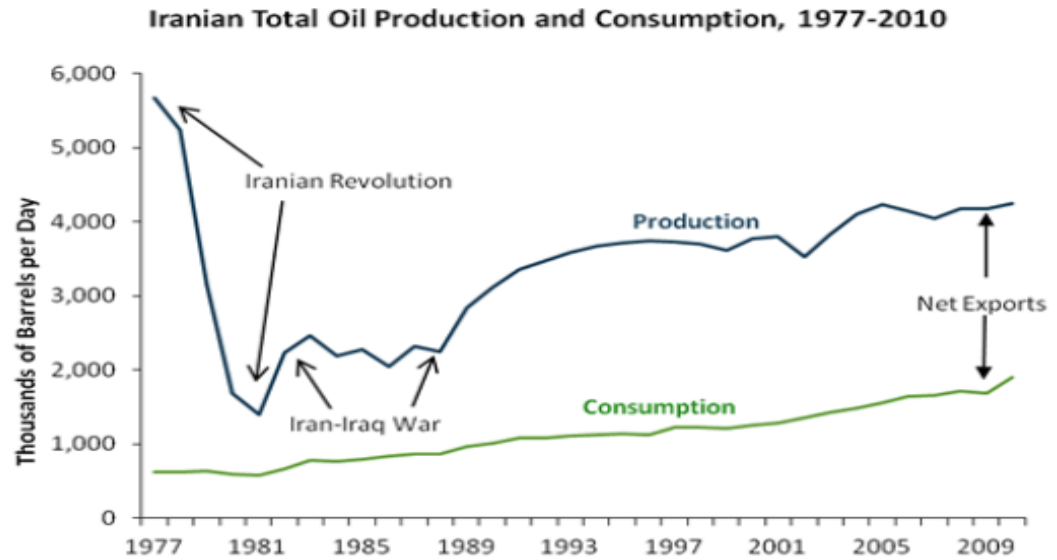
Source: Adapted from DOE/EIA, "Iran, Country Analysis," February 17, 2012, pp. 2, 7

Figure V.2: Iran's Oil and Gas Reserves, Pipelines, and Export Facilities



Source: Adapted from DOE/EIA, "Iran, Country Analysis," February 17, 2012, pp. 1

Figure V.3: Iran's Oil Exports



Source: U.S. Energy Information Administration

Iran's Top Export Destinations, 2010		
Country	000 bbl/d	Share of total (percent)
China	426	20
Japan	362	17
India	345	16
Italy	208	10
South Korea	203	9
Other	610	28
Total Exports	2,154	100

IRAN CRUDE OIL AND CONDENSATE EXPORTS FOR KEY COUNTRIES
January - June 2011

	Percent of Iran's Exports	Total Volume of Crude Imported from Iran ('000 b/d)	Iran as a Percentage of Total Crude Imported
European Union	18	452	
Italy	7	183	13
Spain	6	137	13
France	2	49	4
Germany	1	17	1
UK	<1	11	1
Netherlands	1	33	2
Others	1	22	1
Japan	14	341	10
India	13	328	11
South Korea	10	244	10
Turkey	7	182	51
South Africa	4	98	25
Sri Lanka	2	39	100
Taiwan	1	33	4
China	22	543	11

Source: Adapted from DOE/EIA, "Iran, Country Analysis," February 17, 2012, pp. 3, 4, 5

Figure V.4: Iran’s Gas Pipeline “Dreams”: The Iran-Pakistan-India Pipeline



Source: Adapted from DOE/EIA, “Iran, Country Analysis,” February 17, 2012, pp. 3, 4, 5

Figure V.5: Iran’s Refinery Targets

Iran’s Refining Capacity, 2011	
Refinery	000 bbl/d
Abadan	350
Isfahan	284
Bandar Abbas	232
Tehran	220
Arak	170
Tabriz	100
Shiraz	40
Lavan Island	30
Kermanshah	25
Total Output	1,451

Source: Adapted from DOE/EIA, “Iran, Country Analysis,” February 17, 2012, pp. 6; *Oil and Gas Journal*

The Sanctions Game

These vulnerabilities in Iran’s economy capacity to export explain why sanctions, and related diplomatic efforts, have become a key instrument for the US and its allies in competing with Iranian ambitions. The history of sanctions is complex, their exact impact is often impossible to measure or controversial, and their ultimate success remains uncertain.

However, even a brief survey of the patterns in this aspect of US and Iranian competition do shows that sanctions have already put serious pressures on Iran — pressures compounded by the economic policies and mistakes of the Iranian regime, despite Iranian claims to the contrary. Moreover, the history of sanctions shows they have forced Iran to shift its strategy. Iran has responded by trying to leverage its international economic position through its energy exports, by talking about its right to peaceful nuclear programs, and by trying to exploit Arab-Israel tensions to shift the focus to Israel and away from the threat Iran’s actions pose to Arab states.

US Unilateral Sanctions – A Brief Background

As **Figure V.6** shows, sanctions have been the main diplomatic weapon utilized by the US in competing with Iran across a broad spectrum of issues ever since the overthrow of the Shah. Washington has imposed a growing range of sanctions on Tehran, and these sanctions have focused on Iranian activities ranging from petroleum exports and investments to arms control and non-proliferation measures.

They now block US companies from operating in Iran and give the US a strong incentive to block US firms' foreign competitors from operating there as well. And while their aim has been broad, they have all sought to push the current Iranian regime into changing its behavior by isolating it politically and economically from the international community.

Sanctions: 1980-2009

The first major period of US sanctions began in 1979. US and Iranian relations deteriorated sharply following the Islamic Revolution and after November’s hostage crisis. In response, President Carter laid out a series of economic sanctions that were intended both to punish Tehran and to change its behavior.⁴⁸

The Reagan Administration continued this trend and declared Iran “a sponsor of international terrorism,” making Iran ineligible for various forms of US foreign assistance.⁴⁹ Reagan also prohibited Iran from receiving US arms under the US Arms Export Control Act,⁵⁰ and by

⁴⁸ Sabatini, Richard, “Economic Sanctions: Pressuring Iran’s Nuclear Program,” Monterey Institute for International Studies, Nuclear Threat Initiative, June 24, 2010, <http://www.nti.org>.

⁴⁹ Sabatini, Richard, “Economic Sanctions: Pressuring Iran’s Nuclear Program,” Monterey Institute for International Studies, Nuclear Threat Initiative, June 24, 2010, http://www.nti.org/e_research/e3_economic_sanctions_pressuring_iran_nuclear_program.html#fn1

⁵⁰ The Arms Export Control Act, US Department of State. http://www.pmddtc.state.gov/regulations_laws/aeca.html

Executive Order, a ban was imposed on US imports of Iranian crude oil and all other Iranian imports in 1987.⁵¹

The Iran-Iraq Arms Non-Proliferation Act was signed into law under President H.W. Bush. It included provisions regarding dual-use items with potential military purposes and called for the sanctioning of any person or entity that assisted Tehran in weapons development or acquisition of chemical, biological, nuclear, or destabilizing numbers and types of advanced conventional weapons.⁵²

Unilateral sanctions against Iran expanded further under the Clinton administration. Executive Order 12957 banned all U.S. participation in the development of petroleum in Iran,⁵³ Executive Order 12959 broadened the sanctions to encompass a total trade and investment embargo,⁵⁴ and the Congress overwhelmingly passed the Iran and Libya Sanctions Act (ILSA), expanding US sanctions legislation to cover foreign companies.⁵⁵

The ILSA received an extension during the George W. Bush Administration in 2001 and again in 2006 when it was renamed the Iran Sanctions Act.⁵⁶ Executive Order 13382 was issued, which intended to freeze the assets of proliferators of WMD and their supporters and isolate them financially—eight Iranian entities and external organizations that were believed to be supporting Iranian WMD programs were sanctioned.⁵⁷

In 2006, Congress passed the Iran, North Korea, and Syria Nonproliferation Act (INKSNA), which provided penalties for the transfer to, or acquisition from Iran, of equipment and technology controlled under multilateral control lists (the Missile Technology Control Regime, Australia Group, Chemical Weapons Convention, Nuclear Suppliers Group, Wassenaar Arrangement).⁵⁸

Sanctions Since 2010

As Iran's nuclear program has grown closer and closer to giving Iran actual nuclear weapons production capability, the Obama Administration and the Congress have drastically increased the size and scope of US unilateral sanctions. In 2010, Congress passed the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISAD).

The Act imposed sanctions on any person that makes an investment of \$20 million or more in Iran's petroleum industry; any person that provides Iran with goods, services, technology or information with a fair market value of \$1 million or more for the maintenance or expansion of Iran's production of refined petroleum products; and/or any person that exports more than \$1

⁵¹ Executive Order 12613--Prohibiting imports from Iran, The National Archives. <http://www.archives.gov/federal-register/codification/executive-order/12613.html>

⁵² <http://www.mafhoum.com/press3/108E16.htm>

⁵³ Executive Order 12957. <http://www.iraniantrade.org/12957.htm>

⁵⁴ Executive Order 12959. <http://www.iraniantrade.org/12959.htm>

⁵⁵ Iran and Libya Sanctions Act of 1996, from the congressional record.

http://www.fas.org/irp/congress/1996_cr/h960618b.htm

⁵⁶ <http://www.mafhoum.com/press3/108E16.htm>

⁵⁷ Executive Order 13382. US Department of State. <http://www.state.gov/t/isn/c22080.htm>

⁵⁸ U.S. Department of State. Iran, North Korea, and Syria Nonproliferation Act Sanctions (INKSNA), www.state.gov

million worth of gasoline to Iran or provides \$1 million worth of goods or services that could contribute to Iran's ability to import gasoline.⁵⁹

Since 2010 the United States has focused on isolating Iran economically by targeting Iran's financial and commercial system. In doing so, the US has hoped to obstruct Iran's connections to international markets and dismantle the means by which it conducts economic transactions. This makes sense given the composition of Iran's GDP:

- Industry, including Iranian petroleum and petrochemical products, comprises 45.2% of Iran's GDP.⁶⁰
- Services, including banking and trade-related services, account for 43.9% of its GDP.⁶¹

As a result, US sanctions have affected a number of key sectors in Iran's economy, as has the steady increase in the number and scope of other national and international sanctions.

US sanctions have recently broadened in scope to encompass parties that may facilitate the violation of human rights through tracking and the use of technology. In April 2012, President Obama signed an executive order that allowed for the financial sanctioning and banning of travel to the US of Syrian and Iranian parties that track citizens to facilitate human rights abuses. Amongst the targeted organizations in Iran are the intelligence and law enforcement communities, the IRGC, and an internet provider. Parties with interests in the US that supply technological or financial support or services used by either government in human rights abuses are also subject to the sanctions. Moreover, it is reported that the US is considering sanctions against parties outside of Syria and Iran that supply the governments with technology.⁶²

⁵⁹Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_reports&docid=f:hr512.111.pdf

⁶⁰ CIA World Factbook, Iran.

⁶¹ CIA World Factbook, Iran.

⁶² Bloomberg Businessweek, "Obama Levies New Tech Sanctions on Syria, Iran," Julie Page, April 24, 2012. <http://www.businessweek.com/ap/2012-04/D9UB9DH01.htm> and The White House, Executive Order: Blocking the Property and Suspending Entry Into the United States of Certain Persons With Respect to Grave Human Rights Abuses By the Governments of Iran and Syria Via Information Technology," April 23, 2012. <http://www.whitehouse.gov/the-press-office/2012/04/23/executive-order-blocking-property-and-suspending-entry-united-states-cer>

Figure V.6: Major US Unilateral Sanctions against Iran

Year	Sanction	Content
1979	Executive Order 12170	Blocked all property owned by the Central Bank and the government of Iran within U.S. jurisdiction.
1980	Executive Order 12205	Created an embargo on US exports to Iran
	Executive Order 12211	Imposed a ban on all imports from Iran and prohibited US citizens from traveling to Iran or conducting financial transactions there.
1986	US Arms Export Control Act	Prohibited the sale of U.S. arms to Iran.
1987	Executive Order 12613	Banned all Iranian imports to the US
1992	Iran-Iraq Arms Non-Proliferation Act	Imposed sanctions on any entity that helped Iran develop or acquire weapons of mass destruction or “destabilizing numbers” of advanced conventional weapons.
1995	Executive Order 12957	Banned any American firm or individual from investing in or developing Iranian petroleum products, not including natural gas.
	Executive Order 12959	Banned all American trade and investment in Iran.
1996	Iran and Libya Sanctions Act	Sanctioned foreign firms that conducted business with Iran.
2005	Executive Order 13382	Froze the assets of proliferators of WMD and their supporters and isolated them financially. Eight Iranian entities and external organizations believed to be supporting Iranian WMD programs were designated under the executive order and sanctioned.
2006	Iran, North Korea, and Syria Nonproliferation Act	Penalized entities and individuals for the transfer to or acquisition from Iran since January 1, 1999, of equipment and technology controlled under multilateral control lists (the Missile Technology Control Regime, Australia Group, Chemical Weapons Convention, Nuclear Suppliers Group, Wassenaar Arrangement).
2010	Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010	Imposes sanctions on any person that makes an investment of \$20 million or more in Iran's petroleum industry, any person that provides Iran with goods, services, technology or information with a fair market value of \$1 million or more for the maintenance or expansion of Iran's production of refined petroleum products, and/or any person that exports more than \$1 million worth of gasoline to Iran or provides \$1 million worth of goods or services that could contribute to Iran's ability to import gasoline.
2011	FY 2012 National Defense Authorization Act	The FY 2012 National Defense Authorization Act, signed by the President in January, includes language that sanctions any international bank or financial institution that does business with the Iranian Central Bank (ICB), including purchases of crude oil.

Sabatini, Richard, "Economic Sanctions: Pressuring Iran's Nuclear Program," Monterey Institute for International Studies, Nuclear Threat Initiative, June 24, 2010, <http://www.nti.org>.
http://www.nti.org/e_research/e3_economic_sanctions_pressuring_iran_nuclear_program.html#fn1
http://www.pmdtc.state.gov/regulations_laws/aeca.html
<http://www.archives.gov/federal-register/codification/executive-order/12613.html>
<http://www.mafhoum.com/press3/108E16.htm>
<http://www.iraniantrade.org/12957.htm>
<http://www.iraniantrade.org/12959.htm>
http://www.fas.org/irp/congress/1996_cr/h960618b.htm
<http://www.state.gov/t/isn/c22080.htm>
 U.S. Department of State. Iran, North Korea, and Syria Nonproliferation Act Sanctions (INKSNA), www.state.gov.

International Sanctions – A Competition for Influence

International sanctions have had growing importance since 2006, when the UN Security Council passed Resolution 1737 banning nuclear cooperation with Iran. The UN has now passed seven resolutions on Iran, four of which have imposed sanctions (see **Figure V.7**). The US and Iran, have competed for Russian and Chinese support throughout this process while America's key European allies (Britain, France, and Germany) have played a growing role in shaping sanctions and the diplomatic process that has followed

Figure V.7: UN Sanctions against Iran

Year	Sanction	Content
2006	Resolution 1737	Halted nuclear cooperation with Iran, demanded Tehran's compliance with the IAEA, and froze the assets of persons and organizations linked the Iran's nuclear and missile programs. It also established a committee to ensure that sanctions were implemented correctly.
2007	Resolution 1747	Banned Iranian arms exports.
2008	Resolution 1803	Strengthened travel and financial restrictions on designated Iranian individuals and companies.
2010	Resolution 1929	Imposed a complete arms embargo on Iran, banned Iran from any activities related to ballistic missiles, authorized the inspection and seizure of shipments violating these restrictions, and specifically targeted the assets of the Iranian Revolutionary Guard Corps (IRGC) and the Islamic Republic of Iran Shipping Lines (IRISL).

(Source: <http://www.un.org>)

Not only has the UN implemented new multilateral sanctions, but the European Union and the US have crafted additional sanctions and consistently pushed for broader international adoption of these optional constraints.⁶³ This US led coalition has rolled out strong new limitations on Iranian financial institutions, energy exports, and weapons acquisition. Kenneth Katzman explains that the expanded sanction regime has been widely implemented by US allies, though compliance from Iran's neighbors remains a challenge.

U.S. allies have supported the Obama Administration's sanctions toward Iran, in part because the approach is perceived as not purely punitive, and in part because concerns about Iran's nuclear advancement have increased. U.S. and European/allied approaches have been gradually converging since 2002, when the nuclear issue came to the fore, but as of 2010, an unprecedented degree of global consensus has emerged on how to deal with Iran. There is a degree of consensus among experts that many countries, not only allies of the United States, are complying with the provisions of U.N. sanctions, but there are selected exceptions (discussed below). Implementation appears to be somewhat less complete in Iran's immediate region, perhaps because its neighbors do not want confrontation with Iran and are hesitant to disrupt traditional relationships among traders and businessmen in the region.⁶⁴

Iran has tried to counter by leveraging its economic resources. Non-Western powers such as Russia and China figure prominently in Iran's strategy. Iran has also increasingly sought ties to powers such as Brazil and Nigeria, and to non-democratic governments, including the regimes of Hugo Chavez in Venezuela and Robert Mugabe in Zimbabwe. Iranian strategy is anchored in the conviction that non-Western states share an interest in balancing US and Western power in the international system. As President Ahmadinejad has said, "We [non-Western nations] have to develop a proper coordination [...] to wriggle ourselves from the domination of Western powers."⁶⁵

The European Union and Other Western Nations

Ahmadinejad's inflammatory remarks have also become a symbol of how Iran's behavior has damaged Iran's relations with Europe. His controversial comments on Israel and denial of the Holocaust, which are particularly sensitive issues, have poisoned the diplomatic climate and have destroyed any inroads achieved during the Khatami presidency.⁶⁶

The EU countries imposed sanctions on Iran on July 27, 2010 that exceeded those mandated in Security Council resolutions. Norway, Canada, and Australia all announced similar, though less sweeping, sanctions at the same time as the EU.⁶⁷ The EU did make it clear in late October 2010 that these sanctions did not then prohibit importation of Iranian oil and gas, nor did they ban exports of gasoline to Iran.⁶⁸ This was consistent with the EU's effort to diversify its gas supply options and reduce its reliance on Russian gas imports, which amounted to around 32% of total EU demand in 2008.⁶⁹

⁶³ Matthew Levitt, Financial Sanctions, The Iran Primer, USIP, December 2010.

<http://iranprimer.usip.org/resource/financial-sanctions>

⁶⁴ Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011. Pg.42

⁶⁵ Steven Heydemann, "Iran's Alternative Allies," The Iran Primer, USIP, December 2010.

<http://iranprimer.usip.org/resource/irans-alternative-allies>

⁶⁶ Walter Posch, "Iran and the European Union," The Iran Primer, USIP, December 2010.

<http://iranprimer.usip.org/resource/iran-and-european-union>

⁶⁷ Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011.

⁶⁸ Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011.

⁶⁹ "The Nubucco Pipeline Project: Gas Bridge to Europe?", Mark Rowely, Pipeline and Gas Journal, Vol. 236 no. 9, September 2009. <http://www.pipelineandgasjournal.com/nabucco-pipeline-project-gas-bridge-europe>

This policy changed, however, as Iran's nuclear program became more threatening. A movement led by France and Britain in late 2011, culminated in an agreement by the EU at the end of January 2012 to implement a full import embargo on Iranian crude oil and petrochemicals. This move potentially affected some 450,000 barrels a day of Iranian exports; nearly 20 percent of Iran's average crude exports in 2011 and the source of some 25% of its oil export income. It also affected international insurance coverage of Iran, and all transactions with Iran's state-owned oil company and its main tanker fleet.⁷⁰

There was hesitation by some European governments that centered on ensuring there would be sufficient excess supply—mainly from Saudi Arabia—to prevent a major supply shock. Saudi Arabia, however, stated it would seek to make up the difference, which triggered decisive European action.⁷¹

The EU decision also tracked closely with the US legislation that went into force late in 2011, and which required the President to phase in sanctions in stages that would make it very difficult for other states to buy Iranian oil, by barring transactions with Iran's central bank unless the President granted a waiver for any country or company where the impact would harm the national security interests of the United States. This same legislation tracked with the EU decision in exempting countries that “significantly reduce” imports from Iran.

⁷⁰ Indira A.R. Lakshmanan, “Iran Sanctions Bid Targets Oil, Tanker Companies to Cut Exports,” Bloomberg, Feb 6, 2012 2:26 PM ET; Indira A.R. Lakshmanan, “Global Insurers Targeted in Latest U.S. Bid to Expand Sanctions on Iran,” Bloomberg, Mar 8, 2012 11:10 AM ET; Al Arabiya, “U.S. lawmakers take next step on new Iran sanctions on heels of European embargoes,” Tuesday, 31 January 2012; <http://english.alarabiya.net/articles/2012/01/31/191608.htm>; AP sources: Congress to seek new sanctions targeting all Iranian banks Associated Press, March 6, 2012, http://www.washingtonpost.com/politics/federal_government/ap-sources-congress-to-seek-new-sanctions-targeting-all-iranian-banks/2012/03/06/gIQA1p0XvR_print.html.

⁷¹ Indira A.R. Lakshmanan, “Iran Sanctions Bid Targets Oil, Tanker Companies to Cut Exports,” Bloomberg, Feb 6, 2012 2:26 PM ET; Indira A.R. Lakshmanan, “Global Insurers Targeted in Latest U.S. Bid to Expand Sanctions on Iran,” Bloomberg, Mar 8, 2012 11:10 AM ET; Al Arabiya, “U.S. lawmakers take next step on new Iran sanctions on heels of European embargoes,” Tuesday, 31 January 2012; <http://english.alarabiya.net/articles/2012/01/31/191608.htm>; AP sources: Congress to seek new sanctions targeting all Iranian banks Associated Press, March 6, 2012, http://www.washingtonpost.com/politics/federal_government/ap-sources-congress-to-seek-new-sanctions-targeting-all-iranian-banks/2012/03/06/gIQA1p0XvR_print.html.

The Europeans acted in spite of threats by Iran's Vice President Mohammed Reza Rahimi and Iranian officers to shut off the flow out oil from the Gulf. They also acted after Mohammad Ali Khatibi, Iran's OPEC governor said, on January 17, 2012 that, "Applying the scenario of sanctions on Iran's oil exports to EU members would be economic suicide for the member countries...Regarding the economic crisis in the eurozone, imposing any sanction on Iran's oil will push European countries into a deeper crisis."

These threats were so exaggerated that they would have rung hollow under any circumstances, but they were particularly hollow because Saudi Arabia's oil minister, Ali Al-Naimi, had pleased on January 16th that "We are prepared to meet the increase in global demand as a result of any circumstances." While Iran then responded by indirectly threatening Saudi Arabia, it had no more impact on the Saudis than it did on Europe.⁷²

Moreover, the EU took another critical step, and directed. the EU Society for Worldwide Interbank Financial Telecommunication (SWIFT), to, "discontinue its communications services to Iranian financial institutions that are subject to European sanctions." SWIFT is essential to Iran's international banking because it provides secure communications for more than 10,000 financial institutions and corporations in 210 countries.

SWIFT reported in 2010 that 19 Iranian member banks and 25 financial institutions used the network over 2 million times during the course of the year.⁷³ These institutions included the Central Bank of Iran and other major Iranian banks, including Bank Melli, Bank Mellat, Tejarat Bank, Bank Refah, Future Bank, Persia International Bank, Post Bank and Europäisch-Iranische Handelsbank, and unlike import sanctions, Iran had no alternative to the use of SWIFT.

The Role of Other Importers

As has been pointed out earlier, however, much depends on the policies of other importing states. For sanctions to fully succeed, however, other key importers – the nations shown in **Figure V.8** – must also agree to major reductions in imports and actually make these reductions over time. It is far too early to determine how well such efforts to broaden reductions in imports from Iran will succeed, but key exporters like Saudi Arabia have said they will increase production to help make up for the loss of Iranian exports, and key nations like China have already reached out to Saudi Arabia and other Arab exporters to help reduce their dependence on Iran. According to press reports, estimates by Nat Kern in *Foreign Reports* indicate that China reduced its imports from Iran from an average of 550,000 barrels per day in 2011 to some 285,000 in January 2012. South Korea is discussing reductions of 40,000 barrels a day. It is far too early, however, to know what Iran's other major importers will do.⁷⁴

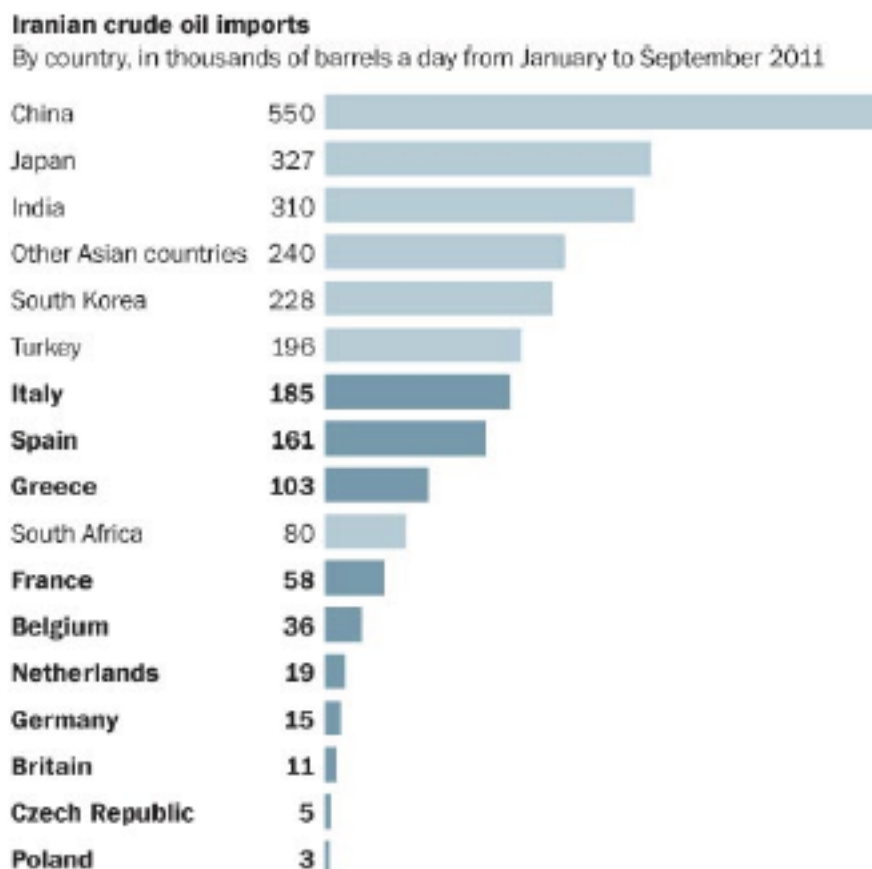
⁷²Associated Press, Iran warns EU oil embargo would be 'economic suicide' for Europe, January 17, 2012.

⁷³ Rick Gladstone and Stephen Castle, "Global Network Expels as Many as 30 of Iran's Banks in Move to Isolate Its Economy," New York Times, March 16, 2012, http://www.nytimes.com/2012/03/16/world/middleeast/crucial-communication-network-expelling-iranian-banks.html?_r=1; Thomas Endbrink and Joby Warrick, "Grim Outlook on Nuclear Talks," Washington Post, March 16, 2012, p. A7.

⁷⁴ David Ignatius, "A slippery slope," Washington Post, January 18, 2012, p. A17.

Figure V.8: Major Importers of Iranian Crude Oil in January-September 2011

(Iran exported some 2.2 million barrels a day in 2011)



Source: International Energy Agency. The Washington Post. Published on January 13, 2012, 7:51 p.m.

Japan and South Korea

Once again, some historical background puts these national issues in perspective. Japan and South Korea are just two of the countries for which sanctions present problems because of their dependence on Iranian imports. Both Japan and South Korea did accede to the US-led unilateral sanctions in September 2010. However, these decisions only came after strong encouragement from the United States.

Both nations had substantial commercial and energy ties to Tehran and were hesitant to endanger their economic interests. Japan and South Korea both imported roughly 10 percent of their crude oil from Iran and leaders in Tehran made it clear that full sanction implementation would not go unnoticed.⁷⁵ The head of the Iranian National Security and Foreign Policy Commission warned that, "Joining the sanctions that are beyond the (UN Security Council) resolutions and are imposed under the US pressure will no doubt be a negative point for those states which comply

⁷⁵ Reuters, "South Korea Imposes New Wave of Iran Sanctions", Jack Kim, September 8, 2010. <http://uk.reuters.com/article/2010/09/08/korea-iran-idUKSGE68707X20100908>

with these illegal decisions [...] Certain countries' compliance with the illegal decisions of the arrogant powers will affect the way the Islamic Republic of Iran interacts with them,".⁷⁶

For Japan, imposing the new sanctions meant that Inpex Corp, a partially state-owned oil developer, abandoned a project to develop the Azadegan field in which they'd already invested \$150 million.⁷⁷ The Koreans endangered billions of dollars' worth of shipbuilding and construction contracts with Iran.⁷⁸ US officials recognized the large economic sacrifices they were asking of their Asian allies and expected a less robust commitment.

This unexpectedly strong move by Tokyo and Seoul reinforced the growing international consensus against the Iranian position. Secretary of State Clinton stated that, "The United States welcomes the announcement by Japan of new sanctions on Iran [...] [They] mark a significant step forward in the international community's efforts to combat proliferation and prevent Iran's development of nuclear weapons."⁷⁹

Senior US counter-proliferation officials successfully lobbied the South Koreans, at the end of 2011, to implement new restrictions on the Iranian nuclear industry, resulting in blacklisting over 100 new firms and individuals. Seoul, however, made clear their intent to continue importing crude oil and petrochemicals from Iran. The Iranian Central Bank maintains accounts in Seoul that it uses to process oil payments, and the Korean government's unwillingness to shut them down would appear to run afoul of the new sanctions language included in the FY2012 Defense Authorization Act. This policy inconsistency will have to be ironed out diplomatically by the US administration and technical and/or legislative remedies will need to be implemented in order to avoid imposing broad-based sanctions on the South Korean financial sector.

As of late-January 2012, Japan and South Korea remained cautious and have not yet committed themselves to anything approaching a total end to Iranian oil imports. Japan's prime minister, Yoshihiko Noda, expressed this caution on January 13, 2012, when he corrected the stronger support his finance minister, Jun Azumi, had given such sanctions a day earlier, and said that his Government would have to consult the business sector, and "Japan's basic stance is to resolve such matters diplomatically and peacefully... We need to consult with the business community, and we need to work out details with U.S. officials. We have to think about the implications for Japanese banks, and what measures are needed to resolve possible negative impact."⁸⁰

South Korea took a similar position. After a visit by a senior US negotiator, Robert Einhorn, the Korean foreign ministry issued a statement that, "The two sides agreed to continue efforts to

⁷⁶ Fars News Agency, "MP cautions S. Korea, Japan against implementing anti-Iran sanctions, September 8, 2011. <http://english.farsnews.com/newstext.php?nn=8906161619>

⁷⁷ UPI, "Iran's drive to halt oil decline falters," August 24, 2011. http://www.upi.com/Business_News/Energy-Resources/2011/08/24/Irans-drive-to-halt-oil-decline-falters/UPI-27401314208450/

⁷⁸ Reuters, "South Korea Imposes New Wave of Iran Sanctions", Jack Kim, September 8, 2010. <http://uk.reuters.com/article/2010/09/08/korea-iran-idUKSGE68707X20100908>

⁷⁹ UPI, "Japan imposes additional Iran sanctions," September 3, 2010. http://www.upi.com/Top_News/US/2010/09/03/Japan-imposes-additional-Iran-sanctions/UPI-87741283534034/

⁸⁰ The Associated Press, "Japanese PM: Govt has yet to decide on reducing Iranian oil imports in line with US sanctions," January 13, 2012; Keith Bradsher and Clifford Krause, "Pressed by U.S., Asian Countries Look for Ways to Reduce Purchases of Iranian Oil," New York Times, January 6, 2012 .

reach an amicable solution that takes into account the interests of our country and companies while achieving the target sought by the U.S.” It seemed likely that both Japan and South Korea would end in largely supporting the sanctions, but not without conditions.⁸¹

India

India has traditionally had close ties to Iran and been unwilling to impose stringent sanctions. India imports some 12 million barrels of Iranian crude oil every month. This accounts for 12 percent of all Indian oil imports, making Iran their largest supplier after Saudi Arabia.⁸² As Iran’s image throughout the Arab world has foundered, however, and international pressure on the regime has increased, India has practiced a more assertive foreign policy with Tehran. Leaked diplomatic cables have revealed India’s growing interest in the Iranian sanction regime. Former foreign secretary Nirupama Rao had asked then US ambassador Tim Roemer in February 2010, “in the future the GOI be accorded the opportunity to take part in pre-sanction consultations.”⁸³

In December of 2010, the Reserve Bank of India made an unexpected decision to prohibit Indian companies from using the Asian Clearing Union (ACU) to pay Iran for oil imports. The ACU allowed companies to functionally launder payments to Iran that may have run afoul of international sanctions.⁸⁴ A key US Treasury official heralded the move as “a significant action” to support US sanctions and further isolate Iran from international financial institutions.⁸⁵

Some experts believe, though, that the fact Delhi stepped away from Tehran had more to do with managing important Indian relationships with the Arab world. P.R. Kumaraswamy, head of West Asian studies at New Delhi’s Jawaharlal Nehru University, observed: “When it comes to Iran, India can ignore pressure from the U.S. and noises from Israel, but it cannot ignore concerns from the Arab countries [...] In a very subtle way, India is sending a message that its closeness with Iran will not affect relations with other Middle Eastern countries.”⁸⁶ By September of 2011, India had resumed payments to Iran by using other financial intermediaries, but tensions between the two countries remain.⁸⁷

⁸¹ Se Yong Lee, “Korea, U.S. Continue Talks on Iran Sanctions,” Wall Street Journal, January 17, 2012

⁸² The Associated Press, “Report: Iran threatens to cut oil supply to India by August if \$5 billion payment not made,” July 18, 2011. <http://www.canadianbusiness.com/article/34462--report-iran-threatens-to-cut-oil-supply-to-india-by-august-if-5-billion-payments-not-made>

⁸³ The Times of India, “India asked US for inclusion in pre-sanction talks on Iran,” September 6, 2011. http://articles.timesofindia.indiatimes.com/2011-09-06/india/30118608_1_nuclear-issue-iranian-foreign-minister-iran-shares

⁸⁴ Indian Express, “US welcomes India bid to restrict trade with Iran,” December 30, 2010. <http://www.indianexpress.com/news/us-welcomes-india-bid-to-restrict-trade-with/730980/>

⁸⁵ Ibid

⁸⁶ Reuters, “India, Iran aim to resolve oil payments impasse,” Nidhi Verma, December 31, 2010. <http://in.reuters.com/article/2010/12/31/idINIndia-53860420101231>

⁸⁷ Bloomberg News, “India clears \$5 billion in overdue oil debt to Iran,” Ladane Nasseri, September 4, 2011. <http://www.bloomberg.com/news/2011-09-04/india-clears-5-billion-in-overdue-oil-debt-to-iran-irna-says.html>

China and Russia

The position of Russia and China on the issue of Iranian sanctions has been one of ongoing concern to both the United States and Iran. The Russians and Chinese are two of Iran's largest economic and energy partners, and their participation in a truly demanding sanctions regime would put severe pressure on Iran -- a situation the Iranians have long sought to avoid. So far, Russia and China have acquiesced to numerous UN sanctions, but have not gone so far as to implement any unilateral sanctions of their own. The formal position of both Russia and China is that they will impose only those sanctions required by applicable UN Security Council resolutions but not impose any sanctions beyond those specifically mandated.⁸⁸ In practice, both states exploit this aspect of US and Iranian competition to some degree, and adapt their positions accordingly.

The unique relationship between China, Russia, Iran, and the United States will be explored more deeply in Chapter 10, but it is important to understand that this is a primary field of strategic competition. Both China and Russia are large, ambitious actors whose ties to both Iran and the US are practical rather than ideological. Beijing and Moscow serve their own interests first and view the Iranian-US contest as more of an opportunity than anything else. Their actions and motivations, therefore, need to be viewed through that prism.

China

China plays a key role in determining the success of any sanctions regime on Iran. Whether the US is seeking compliance with existing sanctions or support for extending and deepening the constraints placed on Tehran, Chinese assistance will be vital to their success. Beijing's enormous demand for energy resources has led to long-standing commercial ties to the Islamic Republic, and they are not afraid to protect those interests at the UN Security Council. This has resulted in the Chinese trying to find a balance that best serves their interests; shielding Iranian commerce to the maximum extent possible while avoiding inflaming their Western partners.

Beijing is keenly aware of its role in the regional competition for influence and view Iran as "a useful hedge against a hostile United States."⁸⁹ This has created a situation where the Chinese have supported the UN sanctions, but denounced the additional measures pushed by the US, Australia, and EU. China's Foreign Ministry spokesman, Qin Gang, observed in 2011 that, "China has noticed the unilateral sanctions announced by the US and others over Iran. The Security Council not long ago adopted the 1929 Resolution on the Iranian issue. China believes that the resolution should be earnestly, accurately and fully implemented, instead of being arbitrarily interpreted and expanded."⁹⁰

China's primary concern is avoiding the possibility of expanded UN sanctions on Iran's energy sector that would affect China's imports. Iran supplies China with around 9% of its oil, down from nearly 15% a few years ago.⁹¹ Beijing only agreed to support the 2010 sanctions

⁸⁸ Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011.

⁸⁹ John W. Garver, *China and Iran: Ancient Partners in a Post-Imperial World* (Seattle: University of Washington Press, 2007), 96.

⁹⁰ "Foreign Ministry Spokesperson Qin Gang's Regular Press Conference on July 6, 2010," Ministry of Foreign Affairs of the People's Republic of China. <http://www.nyconsulate.prchina.org/eng/fyrth/t714568.htm>

⁹¹ The Jerusalem Post, "US and China looking to Middle East for more oil," David Rosenberg, September 9, 2011. <http://www.jpost.com/MiddleEast/Article.aspx?id=237314>

Resolution after the provision was altered to include key exemptions for continued foreign investment in Iran's energy sector.⁹²

A March 2008 diplomatic cable released by Wikileaks quotes a communication between Chinese Arms Control Director General Cheng Jingye and Senate Foreign Relations Committee East Asia specialist Frank Jannuzi. Jingye says that, "China has made clear its need for energy resources and has previously stated that its cooperation with Iran on energy has nothing to do with the Iran nuclear issue. [...] The threat of sanctions against Sinopec [a major Chinese oil company] is a very serious issue. [...] Sinopec is very important to China and Cheng 'can't imagine' the consequences if the company is sanctioned."⁹³

The US has tried to reassure China. In an effort to secure China's cooperation with halting Iran's nuclear program, US officials have told China that they do not have to reduce their Iranian oil and gas imports.⁹⁴ According to a US official quoted in the Washington Post, the US is trying to encourage China to exercise "some near-term pragmatic restraint."⁹⁵ The top US priority, however, is halting the Iranian nuclear program, and the US is willing to make some concessions on strengthening the sanction regime in order to secure China's cooperation on non-proliferation efforts.

Despite China's hesitance to speak out against Iran's nascent nuclear program, it is not eager to confront Washington. An assertive policy toward Iran allows Beijing to exercise a level of regional leadership that rivals that of the United States. Done delicately, though, the Chinese can avoid conflict and flex its muscle without directly challenging broader American leadership in the Asia-Pacific.⁹⁶

Maintaining the freedom to pursue economic ties is obviously important to China, but it is becoming steadily more important to Iran. As the Iranians have become more isolated from the international community over the last few years, their financial relationship with China has accelerated. China went from trading roughly \$14 billion a year with Iran in 2006 to becoming their most significant trading partner in 2009, with bilateral transactions totaling \$21.2 billion.⁹⁷

Iran has strong incentives to continue to build its relationship with China. The international reputation of China may be damaged by maintaining close relations with Tehran, but there is no such risk for the Iranians. While the ethos of self-reliance has been central to Iranian strategy and rhetoric, there is, in fact, very little downside to accepting Chinese largesse.⁹⁸ The Chinese can

⁹² Paul Richter, "West worries China may undermine Iran sanctions efforts," Los Angeles Times, June 28, 2010. <http://articles.latimes.com/2010/jun/28/world/la-fg-iran-sanctions-20100628>

⁹³ "China undercuts sanctions on Iran", Barbara Slavin, Politico, June 2, 2011. <http://www.politico.com/news/stories/0611/56031.html>

⁹⁴ "Chinese firms bypass sanctions on Iran, US says", John Pomfret, The Washington Post, October 8, 2010. http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703723_2.html

⁹⁵ "Chinese firms bypass sanctions on Iran, US says", John Pomfret, The Washington Post, October 8, 2010. http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703723_2.html

⁹⁶ "China-Iran Ties: Assessment and Implications for US Policy", Michael Mazza, AEI Iran Tracker, April 22, 2011. http://www.irantracker.org/analysis/michael-mazza-china-iran-ties-assessment-and-implications-us-policy-april-21-2011#_edn1.

⁹⁷ "China-Iran foreign relations", Ariel Farrar-Wellman, AEI Iran Tracker, July 20, 2010. <http://www.irantracker.org/foreign-relations/china-iran-foreign-relations>

⁹⁸ Michael Eisenstadt, "The Strategic Culture of the Islamic Republic of Iran," MES Monographs No.1, August 2011.

continue to develop Iran's oil fields, provide an enormous market for its oil, supply it with weapons, and serve as an advocate at the UN Security Council. Iran would prefer to have broader access to other international partners, but given the current sanction regime, it will continue to covet Chinese support.

China imported some 11% of its oil from Iran in 2011, but by early 2012 China had both serious concerns about the cost of continuing such imports in terms of US sanctions, and new incentives for turning to other suppliers in the Gulf. China also realized that it could cut back on its ties to Iran under conditions where Iran had no where else to go and would have to turn to China if China offers arms, investment, and restores its past level of imports. And, since as sanctions against Iran had left Tehran with no other arms supplier, China could diversify its energy suppliers without the worry of losing Iranian military contracts.

China, in contrast, could reach out to Saudi Arabia and other Southern Gulf states to secure new trade, arms, and energy deals to compensate it for any losses in dealing with Iran. In January 2012, Chinese Premier Wen Jiabao visited Saudi Arabia, Qatar and the United Arab Emirates, on a six-day tour of key Southern Gulf states. This was the first visit to Saudi Arabia by a Chinese Premier in two decades, and the first to Qatar and the United Arab Emirates.

China took this opportunity to strengthen its energy relationship with those countries by inking a number of business contracts and joint-venture proposals. Sinopec will not only work together with Saudi Aramco on the construction of a new joint oil facility, but they also signed an \$8.5 billion deal to build a new refinery in Yanbu, Saudi Arabia. Sinopec also signed a deal with Royal Dutch Shell and Qatar Petroleum International to build a new refinery in Taizhou.⁹⁹ This is evidence that while Beijing still imports a significant amount of oil from Iran; they are seeking to expand their options in order to hedge against possible disruptions. Over time, China's increasing access to non-Iranian crude is likely to coincide with a shrinking export market for Tehran, as sanctions grow tighter. This will put China in a much more commanding position and may result in Iran losing oil revenue by being forced to offer discounts. This is a situation that the US and its allies would like to encourage, and has some support among Chinese financial institutions who want to preserve access to their US counterparts.¹⁰⁰

Nevertheless, China left its position flexible. Chinese foreign ministry spokesperson Liu Weimin stated at a press conference on January 19th, that China firmly opposed any Iranian or other effort to acquire nuclear weapons, but that, "Using sanctions, imposing pressure and threatening one another with force not only do not help solve the problem, but they would lead to further deterioration of the situation."¹⁰¹

Russia

Russia's situation is different from China's. Russia is a major energy exporter, rather than an importer, and is far less dependent on US trade and economic relations than China is. It also is more willing to openly confront or challenge the US both for foreign policy purposes and for

⁹⁹ Afshin Molavi, "Tehran is Feeling the Squeeze as Beijing Warms up to Riyadh," *The National*, January 23, 2012. <http://www.thenational.ae/thenationalconversation/comment/tehran-is-feeling-the-squeeze-as-beijing-warms-up-to-riyadh>

¹⁰⁰ Michael Wines, "Middle East Trip Suggests Change in Policy by China," *New York Times*, January 13, 2012

¹⁰¹ Voice of America, January 19, 2012, <http://blogs.voanews.com/breaking-news/2012/01/19/china-says-us-sanctions-on-iran-ineffective/>.

domestic political reasons. As a result, the US and Iran still compete for Russian support on an issue by issue basis and much depends on the broader state of US and Russian relations.

Russia's relationship with Iran offers it the opportunity to consolidate and expand its energy network, export arms and other goods to a sizable market, as well as be able to support a counterweight to US regional influence in the Middle East and Caspian Sea. Policy planners in Moscow, however, also value their growing trade relationship with Israel, the benefits of economic integration with the West, and their relations with the Arab states; and are apprehensive about the prospect of a nuclear-armed Iran. These realities have led to their unpredictable and inconsistent support of the Iranian sanction regime.¹⁰²

While Russia has cast its Security Council vote in favor of each of the UN sanction resolutions, it has done so hesitantly and after extracting concessions.¹⁰³ Moscow's interest in diluting the sanction resolutions, however, should not be misunderstood as a strong power attempting to protect a client state. Instead, Russia has used these opportunities strategically in order to advance its own national interests. Crucial exemptions were secured in 2006 that allowed Russia to maintain key contracts with Iran and continue to develop the Bushehr nuclear reactor. After securing his concessions from the Security Council, Russian Foreign Minister Sergey Lavrov said that, "The resolution fully reflects economic interests of Russia and other partners of Iran."¹⁰⁴

Similarly, Russian officials took a hard line against expanding sanctions in 2007 until disagreements over the Bushehr contract brought the two countries into conflict. In the face of soaring construction costs, the Iranians fell behind in their scheduled payments to Moscow.¹⁰⁵ Russian technicians and engineers were called back home, fuel shipments were canceled, and the Russians began to make back-channel ultimatums involving sanctions.¹⁰⁶

A senior White House official then commented that "we're not sure what mix of commercial and political motives are at play here, but clearly the Russians and Iranians are getting on each other's nerves."¹⁰⁷ When the Russians cast their vote for expanded sanctions in March of 2007 they were predictably criticized by the Iranians as having given in to Western pressure. It appears clear, though, that their decision was instead meant to provide leverage in their commercial dispute with Iran. This type of strategic positioning has come to define the Russian approach to Iranian sanctions.

Russian and Iranian commercial relationships grew steadily during the last decade despite international sanctions. Iran has become a substantial market for Russian arms, technology, and agriculture – with annual exports exceeding \$3 billion by 2008. (See **Figure V.9**).¹⁰⁸ Yet, the

¹⁰² Mark N. Katz, "Russia and Iran," The Iran Primer, USIP, December, 2010.

<http://iranprimer.usip.org/resource/iran-and-russia>

¹⁰³ "The U.N. Resolutions", Jason Starr, The Iran Primer, USIP, December 2010.

<http://iranprimer.usip.org/resource/un-resolutions>

¹⁰⁴ "Russian Official Hails Iran Sanctions," The Associated Press, December 26, 2006.

<http://archive.newsmag.com/archives/articles/2006/12/25/90714.shtml>

¹⁰⁵ RIA Novosti, "Iran Hopes Russia Begins to Supply Fuel for Bushehr NPP in March," June 3, 2007.

http://article.wn.com/view/2007/03/06/Iran_hopes_Russia_begins_supplying_fuel_for_Bushehr_NPP_in_M/

¹⁰⁶ The Toledo Blade, "Putin Pulls Plug and Deepens Rift with Iran," March 23, 2007.

¹⁰⁷ Ibid

¹⁰⁸ Mark N. Katz, "Russia and Iran," The Iran Primer, USIP, December, 2010.

<http://iranprimer.usip.org/resource/iran-and-russia>

robust bilateral relations of the 1990s have begun to chill as Iran becomes more isolated from the international community and Russia becomes increasingly interested in a productive relationship with the West. Moscow's strategic acquiescence to sanctions is one of many decisions that have made it clear to Tehran that Russian support is far from assured and instead highly contingent upon their immediate priorities.

Iranian leaders recognize that fostering more reliable ties to Russia would effectively limit America's regional hegemony in the Middle East in addition to reducing the likelihood of a military attack by the US or Israel. The opportunism of their alliance, however, continues to make the Iranians uneasy.

Figure V.9 Russian Trade with Iran 1995-2008

	Exports	Imports
1995	\$249 Million	\$27 Million
2000	\$633 Million	\$57.6 Million
2005	\$1.9 Billion	\$125 Million
2008	3.3 Billion	\$401 Million

(Source: <http://iranprimer.usip.org/resource/iran-and-russia>)

A further cooling of Russo-Iranian relations took place in 2009, when President Obama sought a diplomatic “reset” and Moscow was confronted with opportunities to achieve major national security goals by leaning further toward the West. The Russians were intent on securing a ‘grand bargain’ that would limit NATO expansion, end the development of a Ballistic Missile Defense in Eastern Europe, secure commitments of non-interference, and work toward nuclear parity via a new arms treaty.¹⁰⁹

The United States intentionally linked its approaches to Iran and Russia, seeking Russian support for sanctions and non-proliferation as a key part of its efforts to “reset” US and Russian relations.¹¹⁰ Revelations about Iran's secret uranium enrichment facility at Qom helped solidify the rift between Tehran and Moscow. In 2010, Russia voted in favor of the most recent round of UN sanctions and in order to fully comply, President Medvedev issued a decree canceling all sophisticated arms sales to Iran, including the eagerly anticipated S-300 missile defense system.¹¹¹

¹⁰⁹ “Obama's Diplomatic Offensive and the Reality of Geopolitics,” Reva Bhalla, STRATFOR, March 10, 2009

¹¹⁰ STRATFOR, “Iran, Russia, US: The BMD Link,” February 11, 2009

¹¹¹ “Why Russia is Cutting Off Major Arms Sales to Iran,” Fred Weir, Christian Science Monitor, September 23, 2010

However, Russia's support of sanctions remained sporadic. By early 2011, top Russian officials began to openly question the need for ongoing sanctions and started to challenge western intelligence assessments of Iranian nuclear capacity.¹¹² It was not clear how much this reflected pragmatic policy concerns, a search to gain advantage by supporting Iran, and/or a deterioration in US and Russian relations caused in part by Putin's efforts to limit US influence over the coming Russian election for president. In practice, it probably reflected a combination of all three – although US and Russian relations continued to deteriorate on a broad level in 2012.

In August 2011, Moscow led a seemingly successful effort to lure Iran back into the P5+1 negotiations over their nuclear program, offering to broker a deal that would gradually ease sanctions in exchange for the Islamic Republic meeting transparency targets.¹¹³ Iran's chief nuclear negotiator, Saeed Jalili, declared that the Russian proposal would be the "basis to start negotiations for regional and international co-operation, specifically in the field of peaceful nuclear activities".¹¹⁴

Russia did not support the US and EU expansion of sanctions in late 2011. It not only stated that such sanctions would be counterproductive, but warned that they were increasing the prospect of conflict. Russian Foreign Minister Sergey Lavrov stated on January 18, 2012, that the new sanctions had, "...nothing to do with a desire to strengthen the nuclear non-proliferation...It's aimed at stifling the Iranian economy and the population in an apparent hope to provoke discontent." He also warned that the situation risked leading to attacks on Iran that, "The consequences will be extremely grave. It's not going to be an easy walk. It will trigger a chain reaction and I don't know where it will stop."¹¹⁵

It is again unclear what mix of motives Russia had in taking this position, and the risks of a prolonged confrontation, or a military clash and conflict, cannot be dismissed. What does seem clear is that Russia is likely to continue to use its relationship with Iran in ways designed both to seek its own advantage and to influence US policy toward Russia.

Planners in Moscow have become adept at modulating the extent of their Iranian involvement. Accordingly, the US should not be surprised by tension in one area of their relationship being offset by rapprochement in another. While Iran will continue to compete with the United States for a more dependable alliance, the Russians seem content to keep one foot in each camp--playing the two countries off of each other. They will extract concessions in exchange for their support of future UN sanctions resolutions, but will continue to avoid imposing unilateral sanctions. Their policies will reflect a desire to maintain maximum flexibility in expanding their commercial relationship with Iran while avoiding endangering their increasingly valuable ties to the west.

¹¹² Mark N. Katz, "Russia Balks at New Pressure on Iran," The Iran Primer Blog, USIP, March 16, 2011
<http://iranprimer.usip.org/blog/2011/mar/16/russia-balks-new-pressure-iran>

¹¹³ Lauren Gelfand, "Russia proposes incentives for Iran to comply with UN nuclear programme" Jane's Defense Weekly, August 17, 2011

¹¹⁴ Lauren Gelfand, "Russia proposes incentives for Iran to comply with UN nuclear programme" Jane's Defense Weekly, August 17, 2011

¹¹⁵ Associated Press, "Russia warns attack on Iran could unleash 'chain reaction,' criticizes further sanctions," Updated: Wednesday, January 18, 7:58 AM; CBS News, January 18, 2012,
http://www.cbsnews.com/8301-202_162-57360784/russia-warns-against-more-iran-sanctions/.

Turkey

Iran has long had a suspicious and competitive relationship with Turkey. Some Iranians see Ankara's ties to the West, through NATO and the G-20, as threats to Iran's ability to counter Western hegemony. Turkey's efforts to expand its role in regional leadership also make them a direct competitor to Tehran.¹¹⁶ These fundamental dynamics underlie all Turkish-Iranian relations, even if immediate issues appear to be changing actions and rhetoric at the margins.

The victory of Turkey's Justice and Development Party (AKP) in 2002 did, however, usher in a new era of more constructive engagement between the two countries. Turkish commercial ties to Iran have strengthened under Turkish Prime Minister Erdogan. Tehran now supplies a significant amount of Turkey's oil imports and total bilateral trade has grown to over \$10 billion in 2008.¹¹⁷ Iranian exports in natural gas have also been strong, as the Islamic Republic supplied Turkey with just under 19% of its natural gas imports in 2011.¹¹⁸ The two countries have also cooperated over efforts to dismantle the Kurdish terrorist groups based along the Iraqi/Iranian border. While the United States also considers the PJAK and PKK terrorist organizations, there is some apprehension in the West about this growing military cooperation between Iran and Turkey.¹¹⁹

Other issues have proved more divisive for Turkey and Iran. In recent months, the question of how to respond to violence in Syria has become a point of division, as Iran's clerical leadership remains steadfast in its support for Syrian President Bashar al Assad, while Prime Minister Erdogan has called for Syrian elections. These differences in policy were clearly articulated by both sides during Erdogan's state visit to Iran in March. This episode has placed Turkey in closer alignment with US policy on an issue that has yielded highly-polarized responses from Iran and the US.¹²⁰

As Turkey responds to the Iranian nuclear program, its policy toward sanctions has been shaped by complex strategic interests in Iran, the broader Middle East, and the US. On the one hand, commercial and energy ties to Iran are significant while the Turkish government also maintains that states are entitled to pursue peaceful nuclear energy. Moreover, the importance of Islamic solidarity as a theme in Turkish politics cannot be discounted, especially given the Islamist, albeit moderate, nature of the AKP. Conversely, Turkey must maintain its commitment to nuclear weapons non-proliferation, promote stability in the Middle East and mend a relationship with the US that was strained by the Iraq War. The result has been a policy that emphasizes finding a middle-ground between Iran and the states that take issue with the Iranian nuclear program.¹²¹

¹¹⁶ Henri J. Barkey. "Iran and Turkey," *The Iran Primer*, USIP, December 2010.

<http://iranprimer.usip.org/resource/iran-and-turkey>

¹¹⁷ Ibid

¹¹⁸ Stratfor, "Turkey's Natural Gas Imports 2011." <http://www.stratfor.com/image/turkeys-natural-gas-imports-2011>

¹¹⁹ Hawar Abdulrazzaq, "Analysts watching Turkey-Iran Military Ties, Rudaw in English, August 26, 2011. <http://www.rudaw.net/english/news/turkey/3935.html>

¹²⁰ AP, "Iran, Turkey Sharply Differ on Syria," Ali Akbar, March 29, 2012. <http://news.yahoo.com/iran-turkey-sharply-differ-syria-193901321.html>

¹²¹ Aylin G. Gurzel and Eyup Ersoy, "Turkey and Iran's Nuclear Program," in *Middle East Policy*, XIX, No. 1, Spring 2012.

Like Russia and China, Turkey seeks to preserve policy autonomy on Iran. Mehmet Simsek, the finance minister, told the Financial Times that while Turkey supported UN sanctions, they would not shy away from promoting closer trade links with Iran, saying, “We will fully implement UN resolutions but when it comes to individual countries’ demands for extra sanctions we do not have to [obey].”¹²² This duel game has allowed Turkey to sometimes play the role of mediator. When Iran announced their willingness to return to nuclear talks in January 2012, Turkey volunteered to host—an offer that was quickly accepted by the Iranians.

Prime Minister Erdogan also articulated the limits of Turkish support for the US, the EU, France, Germany, and Britain when he accused the “West” of treating Iran unfairly over its nuclear program.¹²³ Erdogan has tried to downplay the significance of Iran’s nuclear program, dismissing international allegations as merely “gossip.”¹²⁴ These recent decisions to side with Iran over its traditional western allies has introduced a new layer of strategic competition and caused some to believe that there was a crisis of confidence for the United States.¹²⁵

So far, Turkey has indicated that it is considering the new round of US and European sanctions, but may not adopt them. Turkey has reason to be cautious: Turkey has obtained a third of its crude oil from Iran during recent years, and Iran supplied 51 percent of Turkey’s oil imports during the first half of 2011. This helps explain why the Turkish Foreign Ministry spokesman, Selcuk Unal, told a news conference on January 12th that Turkey would not abide by any unilateral or multilateral sanctions against Iran in spite of efforts by US Vice President Biden and a visit by US Deputy Secretary of State William Burns. It also helps explain why Turkey’s energy minister, Taner Yildiz, gave a press conference that same day in which he said that, Turkey was not bound by the new US or EU efforts to reduce Iranian oil exports: “UN sanctions are binding for us...Other decisions are not...At the moment our imports continue and as of today there is no change in our road map.”¹²⁶

It is not clear, however, that such statements really reflect Turkey’s intentions or future policy. Turkish banks had already distanced themselves from Iranian banks as a result of past US sanctions. Tupras, Turkey’s main oil refiner, and a company owned by the Koc Holding conglomerate, had renewed its annual contract to buy Iranian crude in December 2012, but Tupras had stopped selling refined oil to Tehran after the passage of new US sanctions in 2010. Moreover, Halkbank, a state-controlled bank, handled Tupras’ transactions with Iran. But Halkbank had already declined to do business with Iran on behalf of a refiner in India, despite previously supporting Iranian trade with India.¹²⁷ Sanctions on Iran have already had a sharp impact on Turkey’s economy. While Turkish exports to Iran grew significantly year-to-year

¹²² “Turkey throws an economic lifeline to Iran”, Roula Khalaf and Delphine Strauss, Financial Times UK, July 26, 2010. <http://www.ft.com/intl/cms/s/0/611b301e-97d5-11df-b218-00144feab49a.html?ftcamp=rss#axzz1T53j9m88>

¹²³ The Guardian UK, “Turkish PM Exposes Nuclear Rift in NATO”, Robert Tait, October 26, 2009. <http://www.guardian.co.uk/world/2009/oct/26/turkey-iran>

¹²⁴ Henri Barkey, “What’s Turkey’s role in the second round of Iran talks?”, The Iran Primer, USIP, January 10, 2011. <http://iranprimer.usip.org/blog/2011/jan/10/whats-turkeys-role-second-round-iran-talks>

¹²⁵ Henri J. Barkey. “Iran and Turkey,” The Iran Primer, USIP, December 2010. <http://iranprimer.usip.org/resource/iran-and-turkey>

¹²⁶ Daniel Dombey, “Turkey defiant on Iran sanctions,” Financial Times, January 12, 2012.; Turkey defies US over Iran sanctions, PressTV, <http://www.presstv.ir/detail/220788.html>, January 13, 2012.

¹²⁷ Daniel Dombey, “Turkey defiant on Iran sanctions,” Financial Times, January 12, 2012.

from 2009-2011, a 20% drop in Turkish exports to Iran was reported for 2012 thus far, as was an increase in the price of oil imports to Turkey.¹²⁸

More broadly, Ankara has been careful not to let its foreign policy stray too far from Western norms. Turkish Foreign Minister Ahmet Davutoglu, explicitly stated that it would condemn Iran should they renege on their commitment to the Nuclear Non-Proliferation Treaty.¹²⁹ Turkey also made sure to comply, in March of 2011, with the UN by twice forcing the landing of Iranian cargo aircraft. In both cases the aircraft were searched and in one instance weapons were removed that were allegedly bound for Syria.¹³⁰

Ankara's tilt toward the West was evident in September of 2011 when Turkey opened up negotiations to host a key radar installation as part of the NATO early warning missile defense shield. This decision elicited predictable recriminations from Iran,¹³¹ and spurred a top Western official to assert that "Turkey is back in the club."¹³² Turkey's eventual decision to host the American radar was particularly relevant because it not only cemented relations with the US, but did so in a way that was zero-sum with Iran. The Obama Administration has overtly described the missile shield as being designed to deter Tehran, and a top White House official highlighted the importance of Ankara's move by announcing that "This is probably the biggest strategic decision between the United States and Turkey in the past 15 or 20 years."¹³³

More recently, Ankara has acted to avoid US sanctions that target countries that do not scale-back or stop oil imports from Iran. The Turkish Energy Minister stated in March that his country would decrease imports of oil from the Islamic Republic by 10%, while seeking deeper energy trade with Libya and Saudi Arabia. The refiner Tupras indicated that it would scale imports back by 20%, with its Iranian contract expiring in August.¹³⁴

In short, Turkey maintains an independent foreign policy despite the desires of Washington and Tehran, and sometimes seeks to make both countries compete for its allegiance on an issue-by-issue basis. Ankara will continue to position itself as a growing regional power and seek to extend its commercial and diplomatic ties as well as its broader appeal throughout the Arab world.

¹²⁸ The Wall Street Journal. "Iran Sanctions Put Wrinkle in Turkish Trade," Joe Parkinson, March 19, 2012. <http://online.wsj.com/article/SB10001424052970203961204577271281095768586.html>. And Bloomberg, "Iran Sanctions Hitting Turkish Economy, Energy Costs," Indira A.R. Lakshmanan, April 17, 2012. <http://www.bloomberg.com/news/2012-04-17/iran-sanctions-hitting-turkish-economy-energy-costs.html>

¹²⁹ Today's Zaman, "Davutoğlu Blames Israel for Failure to Mend Ties," December 27, 2010. http://www.todayszaman.com/newsDetail_getNewsById.action?load=detay&newsId=230778&link=230778

¹³⁰ Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011.

¹³¹ Tehran Times, "Iran warns over NATO's radar system in Turkey: Minister." September 7, 2011. <http://www.tehrantimes.com/index.php/politics/2267-iran-warns-over-natos-radar-system-in-turkey-minister->

¹³² Today's Zaman. "Turkey reaffirms strong bonds with NATO," Lale Kemal, September 7, 2011. <http://www.todayszaman.com/columnist-256054-turkey-reaffirms-strong-bonds-with-nato.html>

¹³³ The New York Times, "U.S. Hails Deal with Turkey on Missile Shield," Thom Shanker, September 15, 2011. http://www.nytimes.com/2011/09/16/world/europe/turkey-accepts-missile-radar-for-nato-defense-against-iran.html?_r=1

¹³⁴ Reuters, "Turkey to Cut Iran Oil Imports, Bows to U.S. Pressure," Seda Sezer, March 30, 2012. <http://www.reuters.com/article/2012/03/30/us-turkey-iran-oil-idUSBRE82T0KX20120330>

This does not mean that Turkey will not support efforts to end Iran's nuclear program and limit its political and military influence in the region. It does mean it is important for US policy makers to understand that the freelance foreign policy in Ankara does not represent any real allegiance to Iran. In fact, both countries recognize that they are long-term rivals, and that near-term cooperation is driven by expediency and immediate self-interest. Therefore, the US should expect Turkish compliance with UN sanctions, but anticipate some pushback on other, less important, aspects of its regional agenda.

The BRICS

The BRICS states—comprised of Brazil, Russia, India, China and South Africa, states that account for nearly 28% of the global economy—have responded both individually and collectively to the tightening of sanctions by the US and EU in late 2011 and early 2012. As a bloc, the group remains divided over the effectiveness of sanctions to curtail Iranian actions and refuses to endorse either the Western or Iranian position.¹³⁵

Meeting in New Delhi in March 2012 to discuss the creation of a BRICS funded development bank, leaders of the five developing nations announced their commitment to Iran's right to "peaceful uses of nuclear energy", but they also stressed that the situation "cannot be allowed to escalate into conflict."¹³⁶ The leadership of BRICS countries are unified in their desire to maintain or accelerate economic growth taking place in their respective countries and are particularly sensitive to shocks to the global political landscape that might hinder growth. As of yet the BRICS nations are still a loose conglomeration of geographically distinct, non-western states with similar economic interests. Each country has its own particular security interests which preclude the formation of a coherent diplomatic position beyond general desires for peace and continued dialogue.

The Effect of Sanctions

Despite past Iranian rhetoric to the contrary, the existing sanctions are hurting the Iranian economy and their impact will increase steadily over time if they are widened and applied with any consistency. There is no way, however, to be certain of their political and economic effect, or whether what is an escalating process of confrontation between Iran and the US, Europe, Arab Gulf states and other countries will lead Iran into new forms of political and asymmetric warfare or serious clashes or conflict.

Iran has made far franker admissions that sanctions are having a major impact. In a rare declaration by a top Iranian official, President Ahmadinejad declared before Iran's parliament in late 2011 that the current sanctions against Iran were "the heaviest economic onslaught on a nation in history," adding "every day, all our banking and trade activities and our agreements are being monitored and blocked."¹³⁷ Given the growing tension between President Ahmadinejad and Ayatollah Khamenei, these statements should not be taken at face value. As antagonism between Iranian leadership grows, the increasingly marginalized President may be willing to criticize a leadership he sees as political rivals. Still, as only one indicator, Iran's currency, long held

¹³⁵ <http://www.aljazeera.com/news/asia/2012/03/201232972330955836.html>

¹³⁶ http://www.washingtonpost.com/business/brics-hold-4th-summit-in-india-with-focus-on-boosting-trade-gaining-greater-global-influence/2012/03/29/gIQAjGW8hS_story.html

¹³⁷ "Iran's growing state of desperation", Fareed Zakaria, FareedZakaria.com, January 4, 2012.

artificially high by a regime that could afford to subsidize it, lost 35 percent of its value between September 2011 and early January.¹³⁸

The basic economic data on Iran are notoriously uncertain, and far too much analysis focuses on macroeconomic estimates for the total economy that do not provide any reliable way to estimate the impact of sanctions in any detail. There is no reliable way to measure the GDP in purchasing power parity terms, income distribution, per capita income in real terms, inflation, poverty levels, real and disguised unemployment, and the impact of corruption. There is no reliable way to measure the impact of a corrupt state sector whose spending is distorted by unreported shifts in spending to the military and Islamic Revolutionary Guards Corps, a corrupt religious establishment and its “charitable” Bunyods, spending on “civil” nuclear programs, and the real world allocation of the money the state has spent of subsidies and income supplements.

Moreover, Iran may face far more drastic sanctions before the end of 2012. The US has put pressure on the international banking system that could potentially prevent Iran from using the Society for Worldwide Interbank Financial Telecommunication (“SWIFT”) which operates a worldwide financial messaging network which exchanges messages between banks and other financial institutions and makes secure financial transactions possible. At the same time, members of the US Congress have proposed new sanctions that could affect every international banking transaction with Iran, international insurance coverage with Iran, and all transactions with Iran’s state-owned oil company and its main tanker fleet.¹³⁹

Iran’s View of the Economic Impact of Sanctions

The official Iranian message to the world regarding both sanctions and its nuclear programs is that Iran is a developing nation being bullied by a country that feels its post-Cold War hegemony waning. Iran accuses the United States and its allies of using globalization as an instrument of Western power and to impose their will on non-Western states—what Ahmadinejad calls “forced globalization.”¹⁴⁰ Iran has cultivated an image as the voice of all Muslims in confronting an

¹³⁸ “Iranian currency slides under latest U.S. sanctions”, Thomas Erdbrink, Washington Post, January 2, 2012.

¹³⁹ Indira A.R. Lakshmanan, “Iran Sanctions Bid Targets Oil, Tanker Companies to Cut Exports,” Bloomberg, Feb 6, 2012 2:26 PM ET; Indira A.R. Lakshmanan , Global Insurers Targeted in Latest U.S. Bid to Expand Sanctions on Iran, Bloomberg, Mar 8, 2012 11:10 AM ET; Al Arabiya, U.S. lawmakers take next step on new Iran sanctions on heels of European embargoes, Tuesday, 31 January 2012; <http://english.alarabiya.net/articles/2012/01/31/191608.htm>; AP sources: Congress to seek new sanctions targeting all Iranian banks Associated Press, March 6, 2012, http://www.washingtonpost.com/politics/federal_government/ap-sources-congress-to-seek-new-sanctions-targeting-all-iranian-banks/2012/03/06/gIQA1p0XvR_print.html.

¹⁴⁰ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” CRS, 9 June 2011, p.54

imperialist United States —“very helpful to Ahmadinejad’s desire for greatness in the Arab world.”¹⁴¹

The degree to which sanctions and other external economic pressures have affected the Iranian economy has been a central – if changing – theme in Iran’s rhetoric. Key members of the Iranian leadership have repeatedly stated in the past that sanctions have no effect on the country’s economy. On November 13, 2010, the Secretary of Iran’s Expediency Council, Mohsen Rezaei stated that, “so far, sanctions have left no effect on the peoples’ lifestyle.”¹⁴²

Such statements were not uncommon. In late November 2010, a close confidant and adviser to President Ahmadinejad stated that increased financial restrictions and sanctions have had “no noticeable effect” on Iran’s economy.¹⁴³ Shakour Akbarnejad of the Iranian Parliament’s Economic Commission has stated that, “history has shown that sanctions have left no negative impact on the Iranian nation’s movement and we have, in a word, become accustomed to them.”¹⁴⁴

Some Iranian officials have gone so far as to claim that sanctions have benefitted Iran by engendering technological innovation and self-reliance. While speaking to reporters at the 11th exhibition of nuclear achievements at the Islamic Azad University of Mashad on November 13, 2010, the Deputy Head of the Atomic Energy Organization of Iran, Behzad Soltani, proclaimed:

All (Iran’s) achievements acquired in the nuclear industry have been made during the period of sanctions. Western Sanctions have enhanced the level of our nuclear achievements in the country and caused U.S. to develop many nuclear technologies indigenously.¹⁴⁵ On March 6, 2011, Ahmadinejad made similar allusions to the alleged positive effects of sanctions on Iran’s scientific and industrial development, stating that “the Iranian nation learned to rely on their (own) resources and capabilities [...] and as a result, made great scientific achievements” as a result of sanctions.¹⁴⁶

The Iranian government has also attempted to manipulate economic data relating to sanctions, and to make charges about the economic policies of other countries as the cause of Iran’s economic problems. For example, Dr. Seyed Shamseddin Hosseini, the Minister of Economic Affairs and Finance of the Islamic Republic of Iran and Governor of the Bank for the Islamic Republic of Iran, both attacked the policies of the West and World Bank in a statement on the “Necessity to Rethink the World Bank Behavior” at the annual meeting of the IMF on September 23, 2011, and attempted to describe Iran’s economy as a “success:”

These meetings are held at a juncture that we still see the negative consequences of the global crisis on the economic and financial environment. The debt of the United States Government has

¹⁴¹ The New York Times, “US walks out as Iran leader speaks”, Neil MacFarquhar, September 23, 2010. <http://www.nytimes.com/2010/09/24/world/24nations.html?sq=iran&st=cse&adxnnl=1&scp=33&adxnnlx=1311283552-mCIoV4UtUt2CQBW78uZNg>

¹⁴² Fars News Agency “EC Secretary Downplays Effects of Sanctions against Iran,” November 13, 2010. <http://english.farsnews.com/newstext.php?nn=8908221544>

¹⁴³ The Washington Post. “Adviser to Ahmadinejad Says West’s Sanction’s Have Failed.” Erdbrink, Thomas and Serjoie, Kay Armin. November 24, 2010. <http://www.washingtonpost.com/wp-dyn/content/article/2010/11/23/AR2010112307004.html>

¹⁴⁴ Fars News Agency, “MP: Iran’s Targeted Subsidy Plan defU.S.es Effects of Sanctions,” October 30, 2010. <http://english.farsnews.com/newstext.php?nn=8908080913>

¹⁴⁵ Fars News Agency, “Official: Sanctions Accelerate Iran's Efforts to Achieve N. Progress,” November 13, 2010. <http://english.farsnews.com/newstext.php?nn=8908221782>

¹⁴⁶ Mehr News Agency, “Western companies circumventing Iran sanctions”, March 6, 2011. <http://www.mehrnews.com/en/newsdetail.aspx?NewsID=1268563>

exceeded 14 trillion dollars and the impacts of downgrading US credit rating, as well as low economic growth and its negative prospect, has resulted in severe fluctuations in the money, commodities and capital markets.

The Euro Zone, too, faces three contradictory policy challenges, namely implementation of austerity economic measures, low growth rate, and incapability in repaying its debts and honoring financial obligations.

These problems root from the following:

1. The current architecture of the world's economy, due to inconsistency between the financial and the real sectors, creates unavoidable periodical instabilities. Settling this issue requires amending the current financial and monetary models, and shifting toward new models, such as Islamic finance, which are based on the balance between the financial and real sectors of the economy.
2. Political instability influences the economic performance. What is now happening in the MENA region, though appears to be political, doubtlessly deepens the global economic crisis, if the political and military interventions are not avoided.
3. The management of the international monetary and financial institutions has been deviated from its original functions and pursues the political will of some certain shareholders.

Unfair sanctions imposed on countries, such as the Islamic Republic of Iran, and following the will of some certain countries by the World Bank, in drawing up its relations with Iran, is a proof to this point. That the World Bank management, contrary to its Articles of Agreements, avoids approving the Country Assistance Strategy for Iran, and refrains from offering technical assistance to Iran, is another evidence of its deviation.

As the representative of a country that is a founding member of the World Bank, I would like to emphasize on the loyalty of the management of the World Bank to its Articles of Agreement as well as good and corporate governance, instead of biased governance.

Let me briefly inform you of our economic structural and institutional reforms and achievements in recent years: Revising one of the Articles of Constitution improved the role of the private sector, the situation for non-governmental sector and doing business environment. Implementing the economic transformation plan, including targeting subsidies, amending customs, taxation and banking systems, goods and services distribution system as well as currency denomination reform and enhancing productivity are in our agenda.

The achievements of these plans are as per followings:

1. The Targeting Subsidy Plan, focusing on amending the energy carrier prices resulted in a 6 percent reduction in energy consumption. This policy reduced electricity consumption by 2 percent, while prior to implementation of the plan, there was an annual rate of growth of 8 percent.
2. Amending the flour price, reduced its consumption by 30 percent and prevented smuggling to neighboring countries. The savings strengthened the food security and also listed Iran among the exporters of wheat.
3. The revenues of targeting subsidies are redistributed. A cash payment of one and a half dollars a day to 73 million plus Iranian, who have applied for it, led to a sharp fall of Gini Coefficient in Iran.
4. The capital market is developed, and privatizing state-owned firms and issuing Sukuk Bond are done through the stock exchange and OTC. These efforts led to 146 percent growth of stock exchange index and 100 percent growth in market value of Tehran Stock Exchange in December 2010, comparing to the end of 2007

5. Foreign direct investment to the country during 2009 and 2010 experienced 120 percent growth.
6. The growth of non-oil exports in 2009 and 2010 was 24 and 31 percent respectively.¹⁴⁷

There is no firm way to put such claims in perspective, but Iran's leaders have since been more frank about the impact of sanctions. Toward the end of 2011, there was a change in rhetoric coming out of Tehran. In a speech before Parliament, President Ahmadinejad characterized the most recent international efforts as "the most extensive sanctions ever" and that "this is the heaviest economic onslaught on a nation in history...every day, all our banking and trade activities and our agreements are being monitored and blocked."¹⁴⁸ The true effects of sanctions are always opaque, but his rhetorical departure suggests that the renewed international pressure has at least succeeded in forcing a strategic shift by Tehran.

This is in addition to some individuals within the Iranian government who have appraised Iran's economic situation more pessimistically, cautioning their colleagues about the dangers of economic sanctions and criticizing the regime's economic policies. Veteran Iranian politician Akbar Hashemi Rafsanjani said the Islamic Republic was under unprecedented global pressure and that the government was wrong to dismiss the sanctions as no threat to the economy.¹⁴⁹ Mojtaba Vahidi, a former top-level manager who served in Iran's finance and industry ministries for more than 20 years, observed that "the economic crisis [that Iran is] witnessing today is a direct result of the sanctions—and Iranian officials who say otherwise are fooling themselves."¹⁵⁰

Iran's Limited Oil Export Income and Export Vulnerability

Iran's broader economic vulnerabilities are compounded by the fact that its oil revenues have propped up much of the Iranian economy in the past, but have always been limited compared to total national requirements. **Figure V.10** provides additional data that show that Iran's oil revenues are not high in per capita terms, and are only a fraction of the per capita oil earnings of Qatar, Kuwait, and the UAE. To put such data in context, even before the new rounds of sanction in late 2011, the CIA estimated that Iran's per capita income ranked only 101st in the world while a neighbor like Qatar ranked 1st and the UAE ranked 10th even before the new round of sanctions.¹⁵¹

This mix of economic weaknesses and vulnerabilities potentially makes the Iranian threats to "close the Gulf" described in earlier chapters (and repeated in late 2011 and early 2012) a contingency that would be more damaging to Iran than to any of the Southern Gulf exporting states. Iran's economy has long been marginal in meeting the needs of its people. The Iranian government cannot support its people without food, fuel, gasoline, and spare parts imports. It cannot maintain or expand its energy exports if it is at war or outside states refuse to deal with it, and the situation is becoming steadily more difficult for Iran even without the crisis that any Iranian military action that caused a major cut in traffic through the Gulf would cause.

¹⁴⁷ IMF, September 23, 2011, <http://www.imf.org/external/am/2011/speeches/pr16e.pdf>

¹⁴⁸The Washington Post, "Iran's Growing State of Desperation," Fareed Zakaria, January 4, 2012. <http://thecommongood.net/2012/01/irans-growing-state-of-desperation/>

¹⁴⁹ Reuters, "Iran's Rafsanjani chides Ahmadinejad over sanctions", September 14, 2010.

<http://af.reuters.com/article/energyOilNews/idAFLDE68D06L20100914?sp=true>

¹⁵⁰ The Wall Street Journal, "Iran's Economy Feels Sting of Sanctions," Fassihi, Farnaz, October 12, 2010.

<http://online.wsj.com/article/SB10001424052748703735804575535920875779114.html>

¹⁵¹ CIA World Factbook, 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>, accessed January 6, 2012.

*Figure V.10: Comparative Iranian and Other OPEC Oil Income***OPEC Net Oil Export Revenues**

Country	Nominal (Billion \$)				Real (Billion 2005\$)			
	2009	2010	2011	Jan-Nov 2010	2009	2010	2011	Jan-Nov 2010
Algeria	\$42	--	--	\$50	\$38	--	--	\$44
Angola	\$42	--	--	\$50	\$38	--	--	\$44
Ecuador	\$6	--	--	\$6	\$5	--	--	\$6
Iran	\$53	--	--	\$64	\$48	--	--	\$57
Iraq	\$38	--	--	\$43	\$34	--	--	\$38
Kuwait	\$45	--	--	\$52	\$40	--	--	\$46
Libya	\$34	--	--	\$39	\$31	--	--	\$35
Nigeria	\$46	--	--	\$60	\$41	--	--	\$53
Qatar	\$24	--	--	\$33	\$21	--	--	\$29
Saudi Arabia	\$153	--	--	\$184	\$137	--	--	\$162
UAE	\$53	--	--	\$61	\$47	--	--	\$53
Venezuela	\$33	--	--	\$37	\$30	--	--	\$33
OPEC	\$571	\$750	\$847	\$680	\$510	\$660	\$731	\$599

OPEC Per Capita Net Oil Export Revenues

Country	Nominal (\$)				Real (2005\$)			
	2009	2010	2011	Jan-Nov 2010	2009	2010	2011	Jan-Nov 2010
Algeria	\$1,243	--	--	\$1,449	\$1,110	--	--	\$1,276
Angola	\$3,291	--	--	\$3,825	\$2,940	--	--	\$3,369
Ecuador	\$411	--	--	\$446	\$367	--	--	\$392
Iran	\$804	--	--	\$959	\$719	--	--	\$845
Iraq	\$1,305	--	--	\$1,458	\$1,166	--	--	\$1,284
Kuwait	\$16,683	--	--	\$18,795	\$14,907	--	--	\$16,552
Libya	\$5,418	--	--	\$6,124	\$4,841	--	--	\$5,393
Nigeria	\$326	--	--	\$415	\$291	--	--	\$365
Qatar	\$25,204	--	--	\$34,110	\$22,515	--	--	\$30,034
Saudi Arabia	\$5,339	--	--	\$6,298	\$4,770	--	--	\$5,546
UAE	\$10,955	--	--	\$12,191	\$9,788	--	--	\$10,736

Source: http://www.eia.gov/cabs/OPEC_Revenues/Factsheet.html

Adapted

form

Foreign Companies Exiting the Iran Market

One additional effect that sanctions have already had on Iran has been an exodus of foreign companies who see a less favorable outlook in doing business with Iran. None of the existing sanctions ban all trade with Iran, yet because the international community has sought to isolate Iran economically, **Figure V.11** shows that some companies all over the world decided to do business elsewhere.

According to Treasury and State Department officials, at least 80 major banks had committed not to finance exports to Iran or to process dollar transactions for Iranian banks by Ar.¹⁵² Among those that have pulled out of Iran are Credit Suisse and UBS (Switzerland), HSBC and Barclays (Britain), Commerzbank, Dresdner Bank, and Deutsche Bank (Germany), Société Générale and Le Crédit Lyonnais (France) and even the National *Bank* of Fujairah, based in Dubai.¹⁵³ This is only some of the evidence that sanctions are having a significant impact on Iran's economy, although not necessarily on its nuclear program.

Given this exodus, Iran has had to scramble to find alternative ways to import food and other critical supplies, and now Iranian officials are warning of economic pain in the months ahead—precisely the effect that US officials have been hoping for.¹⁵⁴ However, US politicians and outside experts expressed concern in mid-2011 that Asian firms, from China in particular, as well as from Malaysia, Vietnam, and countries in Eastern Europe, were “backfilling”, or moving in to fill the void left by vacating European firms.¹⁵⁵

There was evidence that some Japanese and European companies walked away from lucrative contracts and projects in Iran and feared losing out to their competitors who may be anxious to step in.¹⁵⁶ Yet, most of the potential backfilling companies were perceived as not being as technically capable as those that withdrew from Iran and as Administration officials did not see evidence of such a trend before the new round of sanctions went into effect.¹⁵⁷ In fact, many experts believe that, over time, the efficiency and output of Iran's economy would decline as foreign expertise departs and Iran is forced to work with less capable foreign companies.¹⁵⁸ The impact of new and much stricter sanctions will almost certainly make this worse.

¹⁵²Rachel L. Loeffler, “Bank Shots,” *Foreign Affairs*, April 2009.

<http://www.foreignaffairs.com/articles/64822/rachel-l-loeffler/bank-shots>

¹⁵³Rachel L. Loeffler, “Bank Shots,” *Foreign Affairs*, April 2009.

<http://www.foreignaffairs.com/articles/64822/rachel-l-loeffler/bank-shots>

¹⁵⁴The Washington Post, “In Iran, sanctions aim at shipping lifeline”, Thomas Erdbrink, June 30, 2011.

http://www.washingtonpost.com/world/national-security/in-iran-sanctions-aim-at-shippinglifeline/2011/07/08/gIQAyJgw7H_story.html

¹⁵⁶ The Washington Post, “Chinese firms bypass sanctions on Iran, US says”, John Pomfret, October 18, 2010.

<http://www.washingtonpost.com/wp-dyn/content/article/2010/10/17/AR2010101703723.html>

¹⁵⁷ Kenneth Katzman, “Iran Sanctions,” CRS, June 22, 2011.

¹⁵⁸ Ibid

Figure V.11 Major Non-Petrol Related Foreign Companies Halting Business in Iran, 2010-2011

Country	Company	Field
China (Hong Kong)	NYK	Shipping
Denmark	Maesk	Shipping
Germany	Siemens	Telecommunications
	Thyssen-Krupp	Steel
	Daimler	Automotive
	Munich Re	Insurance
	Allianz	Insurance
	Hannover Re	Insurance
Italy	Finemeccanica	Defense/Transportation
Ireland	Ingersoll-Rand Plc	Manufacturing
Japan	Toyota	Automotive
South Korea	Kia	Automotive
	Hyundai	Automotive
Switzerland	ABB	Engineering
United Kingdom	Lloyds	Insurance
United States	Caterpillar	Construction/Mining
	Huntsman Corp	Chemical Manufacturing
	KPMG	Accounting
	PricewaterhouseCoopers	Accounting
	Ernst & Young	Accounting

Kenneth Katzman, "Iran Sanctions," CRS, 22 June 2011, p. 55

http://www.washingtonpost.com/world/national-security/in-iran-sanctions-aim-at-shipping-lifeline/2011/07/08/gIQAyJgw7H_story.html <http://www.state.gov/r/pa/prs/ps/2011/05/164131.htm>

<http://www.foxbusiness.com/markets/markets/2010/10/01/factbox-foreign-companies-stepping-away-iran/>

Outside Views of the Overall Economic Impact of Sanctions

There are no reliable data as yet that can portray the full impact of the new energy and banking sanctions that the US and EU created during December 20-11-March 2012. The data on Iran in the World Bank web pages on Iran are often dated and many go back to 2009 and 2010.¹⁵⁹ They do reflect real progress in many human development indicators, including the rather ironic fact that twice as many women now graduate from university in Iran as men. The World Bank also states, however, that:

Economic growth increased by 3.5 percent in 2009/10 while prudent macroeconomic policies reduced inflation to about 10 percent and ensured a fiscal surplus. The initial impact of the removal of the substantial energy and food subsidies in December 2010 did not suppress Iran's economic performance despite stricter economic sanctions. Nevertheless, growth is projected to decline to 2.5 percent and inflation to increase to above 20 percent due to the impact of the substantial increase in energy prices.

The Government has launched a major reform of its indirect subsidy system, which, if successful would markedly improve the efficiency of expenditures and economic activities. The overall subsidies were estimated to cost 27 percent of GDP in 2007/2008 (approximately US\$77.2 billion). The Government has opted for a direct cash transfer program while substantially increasing the prices of petroleum products, water, electricity, bread and a number of other products. Preliminary estimates suggest that the government's comprehensive cash transfer program accompanying the ongoing subsidy reform has reduced poverty and regional income disparities significantly.

The fourth round of international sanctions in 2010 have increased the cost of doing business, limited access to foreign direct investments and foreign technologies, and exacerbated international trade and financial transactions. The United Nations Security Council (UNSC) sanctions include a ban on financing and exports related to Iran's nuclear and military programs. Additional sanctions beyond those called for by the UNSC pose constraints on some international financial transactions, particularly in the Euro and the U.S. dollar.¹⁶⁰

The data on the IMF web page do include estimates through 2011 and they reported only 3.5% real GDP growth in 2010 and a drop to 2.5% growth in 2011 in spite of high oil prices and export revenues. The IMF also reported a 22.5% annual rise in consumer prices in 2011 – a doubling over the 2010 rate and enough to seriously erode the value of incomes and saving, the ability to pay for imports, and potentially to fund key aspects of life like marriage, housing, educational expenses, and business expansion and investment.¹⁶¹ (The World Bank estimates an average inflation rate of 22.1% during 1993-2002 and rates ranging from 25.4% to 12.4% during 2003-2010.¹⁶²

The CIA World Factbook does provide more detail on the aspects of the Iranian economy that help reflect the potential impact of steadily tighter sanctions. It notes that Iran is a highly populated country with a total population of some 78 million, a growth rate of 1.25%, and a median age of only 26.8 (25% of the population is 14 years of age or younger). It not only estimates urbanization at 71%, it makes estimates by city that show how critically dependent the most advanced elements of the population are on the market economy: Tehran (capital) 7.19

¹⁵⁹The economic overview ends in 2009. See "Iran, Islamic Rep. at a Glance,"

http://devdata.worldbank.org/AAG/irn_aag.pdf.

¹⁶⁰ IMF, January 18, 2011, <http://www.imf.org/external/country/irn/index.htm>.

¹⁶¹ Ibid

¹⁶² IMF, *World Economic Outlook 2011*, <http://www.imf.org/external/pubs/ft/weo/2011/02/pdf/text.pdf>, pp. 184, 190.

million; Mashhad 2.592 million; Esfahan 1.704 million; Karaj 1.531 million; Tabriz 1.459 million (2009).¹⁶³

The CIA summarizes the state of the Iranian economy before the imposition of the new US and EU sanctions as follows:

Iran's economy is marked by an inefficient state sector, reliance on the oil sector, which provides the majority of government revenues, and statist policies, which create major distortions throughout the system. Private sector activity is typically limited to small-scale workshops, farming, and services. Price controls, subsidies, and other rigidities weigh down the economy, undermining the potential for private-sector-led growth. Significant informal market activity flourishes...Although inflation has fallen substantially since the mid-2000s, Iran continues to suffer from double-digit unemployment and underemployment. Underemployment among Iran's educated youth has convinced many to seek jobs overseas, resulting in a significant "brain drain."¹⁶⁴

Differences over how to estimate the Iranian GDP data provide a warning about the uncertainty in almost every aspect of the data available on Iran and a partial explanation of why experts differ. The CIA puts the GDP at \$818.7 billion in 2010 in purchasing power parity (PPP) terms but only \$357.2 billion in market terms at the official exchange rate – 43% of the PPP total. The CIA also only estimates real growth at 1% in 2010 – less than a third of the IMF and World Bank figures and less than estimated population growth. It estimates industrial production as dropping by 1.1% in 2010, which would mean it dropped more in 2011. It reports a per capita income of \$10,600 in 2010 in ppp terms, which tends to sharply exaggerate the actual income of Iranians, ranks only 103rd in the world and is a fraction of the per capita income of the Arab states in the Southern Gulf.¹⁶⁵

The poverty level data go back to 2007 and are 18%. More meaningfully, the total unemployment estimate for 2010 was 13.2%. It estimates youth unemployment in the 15-24 years of age category was 23% -- 20.2% for males and 34% for women, and at least 715,000 more men and 677,000 more women reached the age where they should enter the labor force in 2010.¹⁶⁶

Such estimates are extremely uncertain in an economy where disguised unemployment (make work jobs which have no productivity gain) is common, but they are a warning of how fragile much of the economy is. Moreover, Iran's more developed sectors are typical of the rentier character of nations dependent on energy export income and the services sector accounts for some 45% of the labor force and 47.9% of the GDP. Moreover, Iran is heavily dependent on imports (\$59 billion in 2010) – not only of fuel but key goods like industrial supplies, capital goods, foodstuffs and other consumer goods, and technical services.¹⁶⁷

¹⁶³ CIA, *World Factbook*, accessed 18 January 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>.

¹⁶⁴ CIA, *World Factbook*, accessed 18 January 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>.

¹⁶⁵ CIA, *World Factbook*, accessed 18 January 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>.

¹⁶⁶ CIA, *World Factbook*, accessed 18 January 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>.

¹⁶⁷ CIA, *World Factbook*, accessed 18 January 2012, <https://www.cia.gov/library/publications/the-world-factbook/geos/ir.html>

It should be stressed that all of these data reflect the status of a troubled and vulnerable economy before the new round of sanction began to have an impact, but that any estimate of the impact of sanctions must be based on data that are so weak and unreliable that they at most can be quantitative opinions.

Other Views of the Impact of Sanctions

It is also important to note that some sources describe less serious impacts. An IMF statement issued on June 13, 2011 did question how much impact international sanctions were then harming Iran's economy. The statement was based on a May 28 to June 9 visit, and indicated that Iran's GDP was growing at a rate of about 3.5%, and that the government had brought inflation down from 25% in 2008 to about 12% in 2010/2011. The IMF also credited the government's privatization program with positive economic effects.

Hassan Hakimian, an economic expert and director of the Middle East Institute at the London School of Oriental and African Studies (SOAS) argued, however, that, "the IMF is on the optimistic side and comes across as rather rash in its judgment. Most independent observers believe that it's too soon to draw such conclusions" Additionally, Hakimian noted, official data about Iran's economy such as inflation and unemployment rates are often disputed both internally and externally.¹⁶⁸ He seems to have been proved correct. The newer IMF data quoted earlier are substantially less favorable for Iran than the June report, as are the CIA data.

Similarly, polls indicated that Iranians still seemed to have faith in their economy before the new round of sanctions in late 2011. Tehran's stock market had seen a huge increase in trade, and there was no clear sign of a significant capital flight.¹⁶⁹ Also, Iran had sizable hard-currency reserves to absorb shocks, and the isolation of its banking sector helped to protect the country from the worst of the global financial crisis.¹⁷⁰ Many then believed that the economic effects of international sanctions may be able to be tolerated by the regime as long as world oil prices remain high, at nearly \$100 per barrel in June 2011.¹⁷¹

It is also difficult to predict the political impact of the new sanctions. Reza Marashi, a former Iran Desk Officer at the US Department of State argued in 2011 that the negative effects of existing sanctions had been serious, but had not affected the regime as much as might be expected:

Sanctions exacerbate this dependence on the government. By raising the costs of doing business in Iran, sanctions slow economic development and decrease employment options for the middle class. When fewer companies invest in Iran, there are fewer jobs for skilled middle-class workers; fewer opportunities to develop professional skills; and less socially conscious investments while the government prioritizes differently to combat foreign pressure. Alternative options for Iran's middle class are increasingly narrow: unemployment, emigration, or becoming state employees. As a result, many middle-class Iranians not employed by the government live on unsustainable sources of income such as second jobs and remittances from family abroad. Survival for the middle class is at best unstable, and the conservative factions in

¹⁶⁸The Guardian UK, "IMF report on Iran's economic success draws skepticism", Saeed Kamali Dehghan, June 17, 2011. <http://www.guardian.co.uk/world/2011/jun/17/imf-report-iran-economic-success>

¹⁶⁹ The Washington Post, "Sanctions begin to compound Iran's severe economic problems", Thomas Erdbrink, October 5, 2010. <http://www.washingtonpost.com/wp-dyn/content/article/2010/10/05/AR2010100505972.html>

¹⁷⁰ The Wall Street Journal, "Iran's Economy Feels Sting of Sanctions," Fassihi, Farnaz, October 12, 2010. <http://online.wsj.com/article/SB10001424052748703735804575535920875779114.html>

power prefer to keep it that way - a struggling middle class focused on making ends meet is easier to control.

Sanctions have in fact strengthened the hand of conservative factions that increasingly disregard economic reforms from the 1990's and early 2000's. Instead, they have favored economic populism and tighter government control of resources. This allows Iranian hardliners to kill two birds with one stone: reallocating resources to lower-class Iranians in an effort to expand their political base, while squeezing middle-class Iranians that are the backbone of Iran's pro-democracy movement. Together, these policies increase the percentage of the population beholden to the state for its livelihood. With no compelling alternative in sight, Iranians are less likely to revolt and bite the proverbial hand that feeds them.¹⁷²

Sanctions and Energy Competition

All of the preceding analysis has helped to show the extent to which Iranian natural energy resources have become an area of competition between the US and Iran and one that directly interacts with sanctions. Iran's reserves rank among the largest in the world—third in global proven conventional oil deposits, second in natural gas deposits, and fourth in production of crude oil.¹⁷³ Regardless of sanctions, no outside power can easily ignore the potential value of energy deals with Iran, although both Iran's policies and sanction deals present serious risks.

Iran Needs Outside Investment At Least As Much as the World Needs Iranian Petroleum and Gas

At the same time, it is clear that Iran needs outside investment and technology at least as much as outside powers need Iranian oil and gas. As has been discussed earlier, Iranian petroleum exports are a key part of Iran's national economy and its government's revenue. Oil export revenues account for more than 20% of their Gross Domestic Product, roughly 80% of Iran's foreign-currency earnings, and more than 60% of its budgetary revenue.^{174,175,176} Iran's energy sector represents such a large share of the Iranian economy that it is as much a vulnerability as a strength.

This presents a set of different challenges and opportunities for the United States and Iran. Competition in this sector primarily plays out with the United States and its allies attempting to expand their unilateral sanctions while Iran attempts to avoid their enforcement. By forcing foreign firms to choose between Iranian and American markets, the US has further tightened sanctions on the Islamic Republic.¹⁷⁷

Iran has responded both through threats and by attempting to circumvent the sanctions, and by posing military threats. Iranian senior officials and officers have threatened to close the Strait of

¹⁷² Reza Marashi, "The Iran Sanctions Fallacy," Al Jazeera, August 26, 2011.

<http://english.aljazeera.net/indepth/opinion/2011/08/20118238150723914.html>

¹⁷³ "Firms Reported in Open Sources as Having Commercial Activity in Iran's Oil, Gas, and Petrochemical Sectors," Government Accountability Office, March 23, 2010, <http://www.gao.gov/products/GAO-10-515R>

¹⁷⁴ Katzman, Kenneth, "Iran: US Concerns and Policy Responses." Congressional Research Service. December 22, 2010. <http://www.fas.org/sgp/crs/mideast/RL32048.pdf>;

Katzman, Kenneth, "Iran Sanctions." Congressional Research Service. December 13, 2010.

<http://www.fas.org/sgp/crs/mideast/RS20871.pdf>;

¹⁷⁵ Katzman, Kenneth, "Iran Sanctions." Congressional Research Service. December 13, 2010.

<http://www.fas.org/sgp/crs/mideast/RS20871.pdf>;

¹⁷⁶ Economist Intelligence Unit - Iran Data, The Economist, October 2010

¹⁷⁷ Katzman, Kenneth, "Iran Sanctions." Congressional Research Service. December 13, 2010.

<http://www.fas.org/sgp/crs/mideast/RS20871.pdf>

Hormuz to international shipping if sanctions continue, warning explicitly that Iran can and will block the straits in response to “any act of aggression or adventure.”¹⁷⁸ It is doubtful, however, that Tehran would be able to effectively close the Strait, and such a move would endanger their relations with all countries who transport cargo through the area.

Effect of Sanctions on Iran’s Energy Sector

There are indications that existing sanction caused substantial injury to the energy sector before the US and EU imposed far stronger sanctions in late 2011 and early 2012. State Department Special Advisor Robert Einhorn testified on July 29, 2010, that about \$50 billion of investment in Iran’s energy sector had been deterred by sanctions and other forms of pressure.¹⁷⁹ Some US officials have put the figure closer to \$60 billion in lost investment.¹⁸⁰

Multiple companies have been sanctioned under the 2010 Comprehensive Iran Sanctions, Accountability and Divestment Act, the most far-reaching sanctions implemented since the 1979 revolution.¹⁸¹ As a result of these sanctions, several major energy firms have pulled out of some of Iranian projects, declined to make further commitments, or resold their investments to other companies (See **Figure V.12**). Observers have reported little new investment in Iranian energy fields, with the absence of development particularly damaging at the massive South Pars gas field.¹⁸²

Possibly as a result of foreign companies ending business and investment, Iran’s oil production fell to about 3.8 million barrels per day (mmbd) from about 4.1 mmbd in the mid-2000s, and was projected to fall to about 3.3 mmbd by 2015 before the new sanctions were imposed.¹⁸³ Although Iran remains a relatively minor natural gas exporter, some maintain that Iran’s gas sector can more than compensate for declining oil exports.¹⁸⁴ Given the current political climate, it is highly unlikely that Iran will attract the \$145 billion in new investment by 2018 that Tehran’s deputy Oil Minister has said Iran needs in order to develop its gas sector.¹⁸⁵

Some Iranian officials have acknowledged this vulnerability. In recent years, record oil prices insulated Iran from international sanctions and allowed the government to pursue populist policies intended to raise living standards of ordinary Iranians. From 2005, when Ahmadinejad came to power, until 2010, Iran took in nearly \$500 billion in total oil revenue, more than the combined earnings of all previous Iranian governments since the 1979 revolution.¹⁸⁶ But recent

¹⁷⁸ Fars News, “Senior MP: Iran Capable of Blocking the Strait of Hormuz,” April 26, 2010, <http://english.farsnews.com/newstext.php?nn=8902061586>. See also Tehran Times, “Sayyari: Iran Powerful enough to Close the Hormuz Strait,” November 30, 2008, http://www.tehrantimes.com/Index_view.asp?code=183642; and “IRGC Official: Persian Gulf Security is for All or None,” IRNA, August 1, 2010, <http://www.globalsecurity.org/wmd/library/news/iran/2010/iran-100801-irna01.htm>.

¹⁷⁹ Testimony of *Special Advisor Robert Einhorn*. House Committee on Oversight and Government Reform. July 29, 2010 http://democrats.oversight.house.gov/images/stories/Hearings/Committee_on_Oversight/2010/072910_Iran_Sanctions/TESTIMONY-Einhorn.pdf.pdf

¹⁸⁰ Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011, p. 56-57

¹⁸¹ http://www.acus.org/new_atlanticist/china-undercuts-sanctions-iran

¹⁸² Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011, p. 56-57

¹⁸³ The Wall Street Journal, “Irans falling oil output means less revenue, clout,” Spencer Swartz, June 26, 2010. <http://online.wsj.com/article/SB10001424052748704569204575328851816763476.html>

¹⁸⁴ Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011.

¹⁸⁵ <http://www.gao.gov/products/GAO-10-515R>

¹⁸⁶ Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011.

moves by the United States and Saudi Arabia are beginning to test Iran's economic reliance on oil.

According to Reza Zandi, an independent oil and gas expert based in Iran, "The Americans and Saudis are using oil as a weapon against us,"¹⁸⁷ The two countries worked in tandem to lower oil prices after OPEC—with Iran serving as chairman—decided against doing so at its June 8 2011, meeting.¹⁸⁸ The Obama administration released a portion of the U.S. strategic oil reserve, and Saudi Arabia simultaneously pledged to unilaterally increase production, which caused the price of oil to quickly drop by close to \$8 a barrel—a price that has since rebounded as of July 2011.¹⁸⁹

Adding Banking Sanctions to Energy Sanctions

Even before the EU instructed SWIFT to halt transactions with Iranian banks and financial institutions, Iran encountered serious and growing problems in finding financial institutions willing to handle Iranian payments to energy companies as well as processing foreign payments for its exported oil. Traders and oil company officials said European and Middle Eastern banks have all but stopped issuing letters of credit with Iranian financial institutions, making it very difficult to transact payments for oil sales.

Shipping companies began refusing to send tankers to Iranian oil terminals, and insurers became steadily more reluctant to cover cargoes.¹⁹⁰ This indicates that US strategy is having an effect, and Peter Pham of the Atlantic Council predicts that, "At some point or another, Iran's shrinking pool of partners will conclude that the cost of doing business with it is too high."¹⁹¹ As Tehran confronts a dwindling number of financial institutions willing to facilitate its commerce, Chinese banks may become the last remaining source of finance for Iranian trade.¹⁹²

Even those foreign banks that were still doing business with Iran were having growing trouble in financing energy deals. Reports have shown that some Iranian officials are growing increasingly angry about the inability of Iran's largest oil customers to pay in US dollars or Euros, a problem that has contributed to a shortage of hard currency and complicated the central bank's attempts to bolster the Iranian Rial, which has been sharply devalued as of late.¹⁹³

Indian refiners faced crude supply disruptions from Iran, because they can no longer process payments since the Reserve Bank of India, in December 2010, barred trade-related payments to the Asian Clearing Union.¹⁹⁴ By September of 2011, India had resumed payments to Iran by

¹⁸⁷ The Washington Post, "In Iran, sanctions aim at shipping lifeline," Thomas Erdbrink, July 10, 2011. http://www.washingtonpost.com/world/national-security/in-iran-sanctions-aim-at-shipping-lifeline/2011/07/08/gIQAyJgw7H_story_1.html

¹⁸⁸ Kenneth Katzman, "Iran Sanctions," CRS, 22 June 2011.

¹⁸⁹ Kenneth Katzman, "Iran Sanctions," CRS, 22 June 2011.

¹⁹⁰ Reuters, "Iran shipping companies face more heat," Jonathan Saul, May 24, 2010.

<http://www.reuters.com/article/2011/05/24/iran-shipping-sanctions-idUSLDE74N16T20110524>

¹⁹¹ Ibid

¹⁹² The Financial Times, "Sanctions put choker on Iran oil exports," Javier Blas, September 14, 2010.

http://www.ft.com/intl/cms/s/8efd517e-bf5d-11df-965a-00144feab49a,dwp_uuid=c91807cc-1c27-11dd-8bfc-000077b07658,print=yes.html

¹⁹³ The Financial Times, "China and Iran plan oil barter," Najmeh Bozorgmehr, July 24, 2011.

<http://www.ft.com/intl/cms/s/0/2082e954-b604-11e0-8bed-00144feabdc0.html#axzz1T53j9m88>

¹⁹⁴ The Wall Street Journal, "India looks beyond Iran for oil," Rakesh Sharma, July 19, 2011.

http://online.wsj.com/article/SB10001424052702303661904576455290145486746.html?mod=googlenews_wsj

using other financial intermediaries, but it is unclear how long the present arrangement will last.¹⁹⁵

The EIA reports that:

In 2011, Iran experienced significant problems with receiving payments from India for its exports, when the Reserve Bank of India halted a clearing mechanism due to sanctions. Some of the payments have been cleared through Turkish and UAE banks. More recently, NIOC announced that India has cleared all oil debts to Iran through Gazprombank of Russia and Iran has already received all overdue payments for its exports to India.

US financial sanctions blocked China from paying at least \$20bn for oil imports, leading Tehran and Beijing to initiate talks about using a barter system to exchange Iranian oil for Chinese goods and services in order to circumvent sanctions.¹⁹⁶

These problems are almost certain to grow far worse now that EU has directed SWIFT to “discontinue its communications services to Iranian financial institutions that are subject to European sanctions.” SWIFT affects at least 19 Iranian member banks and 25 financial institutions, including Bank Melli, Bank Mellat, Tejarat Bank, Bank Refah, Future Bank, Persia International Bank, Post Bank and Europäisch-Iranische Handelsbank.

Iran has no alternative to the use of SWIFT, and it is likely to face even more serious problems during 2012 as the US Congress passes additional sanctions on Iran’s banks and ability to conduct foreign trade. March 2012, the U.S. Senate and House of Representatives continue to work on bills that would seek to blacklist essentially every Iranian bank, threaten penalties against European and other overseas companies that deal with any of these banks, and to target communications, software and technology companies that continue doing business with Iranian banks.¹⁹⁷

This legislation would interact with the EU action on SWIFT, and affect all Iranian institutions and any foreign institution that acted a front or cover for Iran. Members of Congress state that while the U.S. Treasury has already blacklisted 23 Iranian banks, Iran is using more than 20 other banks to finance its nuclear program and support for regional militant groups.¹⁹⁸

Nevertheless, the recent rise in oil prices amid uncertainty and upheavals in the Middle East could still create a limited “cushion” for Iran. Prices are likely to remain high and volatile as long as protests and concerns about supply disruptions continue across the region. The global economy has limits on how long it can tolerate extremely high prices, but Iran will be able to paper over its fundamental economic problems as long as it can move its oil into export markets.

Though many Western companies have fled from Iran, most of these corporations remain interested in exploring profitable Iranian projects in the future, if possible. Over 1,500 firms from

¹⁹⁵ Bloomberg News, “India clears \$5 billion in overdue oil debt to Iran,” Ladane Nasser, September 4, 2011. <http://www.bloomberg.com/news/2011-09-04/india-clears-5-billion-in-overdue-oil-debt-to-iran-irna-says.html>

¹⁹⁶ The Financial Times, “China and Iran plan oil barter,” Najmeh Bozorgmehr, July 24, 2011. <http://www.ft.com/intl/cms/s/0/2082e954-b604-11e0-8bed-00144feabdc0.html#axzz1TPEoItVf>

¹⁹⁷ Laurence Norman and Jay Soloman, “EU-US Split on Iran Banks Seen as Widening,” Wall Street Journal, March 16, 2012.

¹⁹⁸ Laurence Norman and Jay Soloman, “EU-US Split on Iran Banks Seen as Widening,” Wall Street Journal, March 16, 2012.

40 countries—including Germany, Austria, Australia, Spain, UK, Russia, Switzerland, Sweden, the Netherlands, Norway, Turkey, France, India, Singapore, Japan, China, Thailand, the UAE, Canada, and Brazil—attended the 16th International Oil, Gas, Refining and Petrochemical event in Tehran in April 2011.¹⁹⁹

¹⁹⁹ Sadeq Dehqan, “More Foreign Firms At Oil Expo,” *Zawya*, April 19, 2011.

Figure V.12: Energy Firms Ending Business with Iran 2009-2011

Country	Company	Action
France	Total	Ended investments in Iran
Germany	Linde	Stopped all business
	Schlumberger	Will exit Iran 2013
India	Reliance	Stopped sales of refined products; will not import crude oil from Iran
Italy	Eni spA	Ended investments in Iran
Japan	Inpex Corp.	Exited from the Azadegan oil field
Kuwait	Independent Petroleum Group	Stopped sales of refined products
Malaysia	Petronas	Stopped sales of refined products
Netherlands	Royal Dutch Shell	Ended investments in Iran
Norway	Statoil	Ended investments in Iran
South Korea	GS Engineering & Construction	Cancelled a \$1.2 billion gas processing project in Iran
Spain	Repsol	Abandoned negotiations over development of phases 13 and 14 of the South Pars gas field.
Switzerland	Vitol	Committed to not supply refined petroleum products to Iran
	Glencore	Committed to not supply refined petroleum products to Iran
	Trafigura	Committed to not supply refined petroleum products to Iran
Turkey	Tupras	Cancelled contracts to supply gasoline to Iran
United Kingdom	BP	Stopped supplying jet fuel to Iran Air at Germany's Hamburg airport; halted a BP-NIOC (National Iranian Oil Company) joint venture in the Rhum gas field
International	Trans-Adriatic Pipeline	The pipeline will not be used to transport Iranian gas to Europe

<http://www.state.gov/r/pa/prs/ps/2011/05/164131.htm>

Kenneth Katzman, "Iran Sanctions," CRS, 22 June 2011, p. 56-57

<http://www.state.gov/r/pa/prs/ps/2011/05/164131.htm>

<http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=7066132>

<http://online.wsj.com/article/SB10001424052748704779704575553440314351522.html>

<http://www.foxbusiness.com/markets/markets/2010/10/01/factbox-foreign-companies-stepping-away-iran/>

Gasoline and Product Imports – Iran’s Energy Import Problem

As has been discussed earlier, Iran has another critical vulnerability. It has never had refinery capacity to sufficient to produce enough petroleum products to meet its own domestic needs, and American and allied sanctions have helped constrain Iran’s gasoline production, refining capacity, and imports. Currently, Iranian refineries can only fulfill 58% of local gasoline demand, which itself relies on support in the form of heavy state subsidies.²⁰⁰ Iran is dependent on gasoline imports for 25% to 35% of its consumption, which costs the government between \$5 and \$7 billion annually.²⁰¹

These costs are expected to rise as major insurance companies providing coverage for Iranian shipping exit the market. Some firms that have traditionally worked with Iran have recently received US credit guarantees or contracts.²⁰² Additionally, German insurance giants Munich Re, Allianz, Hannover Re, as well as Britain’s Lloyds of London—Iran’s primary insurer—have all ended their business with Iran as of July 2010.²⁰³²⁰⁴

This is in addition to the numerous international gas suppliers that have discontinued supplying gasoline to Iran.²⁰⁵ Of the top eleven companies providing gasoline to Iran in 2010, all but three—two owned by China, one by Russia—have since ended their sale of gasoline to the Islamic Republic.²⁰⁶ This has, by some accounts, resulted in gasoline imports dropping from about 3.5 million barrels per day to roughly 900,000 barrels per day.²⁰⁷ This nearly 75% reduction is largely the result of international pressure and sanctions. The US Department of State estimates that, all told, Tehran has been denied \$50 to \$60 billion worth of upstream energy revenue.²⁰⁸²⁰⁹

In an effort to compensate for its limited ability to import gasoline, Iran has attempted to increase its domestic production of petroleum products, but has encountered difficulties. Tehran began converting petrochemical plants into refineries and has dedicated \$2.2 billion for accelerated renovations and improvements to existing gasoline refineries. Iranian domestic gasoline, however, contains 10 times more harmful particles than the imported version that, may contribute to increased pollution, smog, and health problems.²¹⁰

Iran’s drive to ramp-up domestic production culminated in September of 2010 when Oil Minister Massoud Mirkazemi proclaimed that Iran had become self sufficient and had halted all gasoline

²⁰⁰ Ebel, Robert, “Geopolitics of the Iranian Nuclear Energy Program,” Center For Strategic and International Studies, March 2010, http://csis.org/files/publication/100312_Ebel_IranNuclear_web.pdf

²⁰¹ Ibid

²⁰² GAO-10-967R, “Exporters of Refined Petroleum Products to Iran,” September 3, 2010.

²⁰³ Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011

²⁰⁴ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” CRS, 9 June 2011

²⁰⁵ The Financial Times, “Traders cut Iran petrol line,” Javier Blas, September 14, 2010.

²⁰⁶ Kenneth Katzman, “Iran Sanctions.” Congressional Research Service. December 13, 2010.

<http://www.fas.org/sgp/crs/mideast/RS20871.pdf>; Country Analysis Briefs – Iran, Energy Information Agency, January 2010, <http://www.eia.doe.gov/emeu/cabs/Iran/Full.html>; “Factbox: Foreign Companies stepping away from Iran,” Reuters, September 23, 2010, <http://www.reuters.com/article/idUSTRE68M1Q120100923>

²⁰⁷ Information provided at Foundation for Defense of Democracies conference on Iran. December 9, 2010.

²⁰⁸ Kenneth Katzman, “Iran Sanctions,” CRS, 22 June 2011. <http://www.fas.org/sgp/crs/mideast/RS20871.pdf>

²⁰⁹ National Review, “Beyond Sanctions,” Juan Zarate, September 20, 2010

²¹⁰ The Wall Street Journal, “Iranians blame smog on West’s sanctions,” Farnaz Fassihi, December 11, 2010.

imports²¹¹ Their decision to invest in domestic refining was made necessary by Western sanctions, and Tehran appears dedicated to further building their refining capacity in order to minimize the effects of international pressure. In July 2010, Iranian Deputy Oil Minister announced an ambitious new plan to invest \$46 billion in upgrading nine existing refineries and constructing nine brand new facilities.²¹²

In addition to boosting production, Iran has also undergone major reforms in an effort to reduce domestic demand for gasoline and petrol product. The Targeted Subsidies Reform discussed earlier made Iran the first major energy producing country to make dramatic cuts to subsidies on energy products and replace them with across the board energy dividend transfers to the population.²¹³ A recent report by the IMF observes that the phase-out of gasoline subsidies has already begun to reduce demand:

The increases in prices of energy products, public transport, wheat, and bread adopted on December 19, 2010, are estimated to have removed close to US\$60 billion (about 15 percent of GDP) in annual implicit subsidies to products. At the same time, the redistribution of the revenues arising from the price increases to households as cash transfers has been effective in reducing inequalities, improving living standards, and supporting domestic demand in the economy. The energy price increases are already leading to a decline in excessive domestic energy consumption and related energy waste. While the subsidy reform is expected to result in a transitory slowdown in economic growth and temporary increase in the inflation rate, it should considerably improve Iran's medium term outlook by rationalizing domestic energy use, increasing export revenues, strengthening overall competitiveness, and bringing economic activity in Iran closer to its full potential.²¹⁴

This reform package has been controversial within Iran, however, as the population adjusts to substantially higher prices, a situation that the government had claimed could be avoided. Some reports have concluded that a person living in a 90 square meter apartment who paid \$3-4 a month for gas will now pay around \$97 for the same level of consumption.²¹⁵ Some speculate that the increased economic pressure on the middle class could lead to widespread protests against the government, but this has not yet occurred.²¹⁶ It may well occur as the new sanction have more and more effect.

Circumventing Energy Sanctions

There still are limits to the combination of old and new sanctions regimes, driven in part by the world's steadily growing need for oil imports. The UN sanctions—partly as a concession to Russia and China—do not place limitations on oil or natural gas transactions. The US has decided, then, to encourage other countries to adopt independent sanctions on the Iranian energy sector. Many European and Asian countries have complied with the expanded sanctions, but as long as the Chinese and Russians continue to implement only the UN sanctions, Iran will continue to have access to large export markets.

²¹¹United Press International, "Iran Halts Gasoline Imports," September 20, 2010.

http://www.upi.com/Business_News/Energy-Resources/2010/09/20/Iran-halts-gasoline-imports/UPI-47021284993256/

²¹² Kenneth Katzman, "Iran Sanctions," CRS, June 22, 2011..

²¹³ The wall Street Journal, "Iranians, Given No Choice, Adjust to Soaring Prices," January 20, 2011.

²¹⁴ Statement by IMF Article IV Mission to the Islamic Republic of Iran, Press Release no. 11/228, June 13, 2011. <http://www.imf.org/external/np/sec/pr/2011/pr11228.htm>

²¹⁵International Affairs Review, "It's all about the price of watermelon: Subsidy reform in Iran," Reza Akbari and Monica Witt, March 28, 2011. <http://www.iar-gwu.org/node/291>

²¹⁶ Ibid

China could still play a key role in helping Iran circumvent Western energy sanctions. China is latecomer to international energy markets, and has found that most of the oil and gas assets in stable and transparent countries are already nationalized or owned by Western oil companies. China has enormous energy needs, however, and this has helped lead it decided to invest in the past countries where US sanctions forbid American and European companies from doing business, such as the Sudan and Iran.²¹⁷ As a result, Iran has become one of the largest suppliers of China's foreign oil, providing 11% of its oil imports in 2009.²¹⁸

In March of 2008, a US diplomatic cable reported a conversation between Chinese Arms Control Director General Cheng Jingye and Senate Foreign Relations Committee East Asia specialist Frank Jannuzi. Jimgye warned that, "China has made clear its need for energy resources and has previously stated that its cooperation with Iran on energy has nothing to do with the Iran nuclear issue. ... The threat of sanctions against Sinopec [a major Chinese oil company] is a very serious issue. ... Sinopec is very important to China and Cheng 'can't imagine' the consequences if the company is sanctioned."²¹⁹

Iran bought half of its gasoline imports in July 2011 from Chinese sellers, amounting to approximately 45,000 barrels per day.²²⁰ This relationship has led China to resist against any UN sanctions in the past, and the fact that 166 Chinese firms attended the 16th International Oil, Gas, Refining and Petrochemical event held in Tehran in April 2011, is a warning that China's energy ties to Iran could still grow stronger.²²¹

As has been touched upon earlier, Russia and Turkey have resisted expanded sanctions and part of this is for energy reasons. Iran and Russia have pursued economic partnerships around the export and refining of oil and gas given that they both possess some of the largest reserves in the world.²²²²²³ Moscow, however, controls enough resources and infrastructure to be largely independent of Tehran, so this energy relationship is currently expedient, but not necessarily permanent. Tehran and Ankara have a complicated relationship, but Turkey represents a potentially profitable energy partner for Iran. Turkey has asserted that UN and US sanctions will not prevent its cooperation with Iran in supplying its own and Europe's growing energy needs.²²⁴

Turkey and Iran have discussed the construction of a pipeline that would deliver Iranian oil across Turkey to Europe, possibly expanding the scope of Iran's oil markets in Central and Western Europe.²²⁵ The Nabucco Project is a proposed 3,300-km gas pipeline starting at the

²¹⁷ Susan Shirk, *China: Fragile Superpower* (New York: Oxford University Press, 2007), 138.

²¹⁸ People's Daily Online, "Saudi Arabia, Angola, Iran remain top 3 oil suppliers to China," February 10, 2010. <http://english.peopledaily.com.cn/90001/90778/90858/90863/6892818.html>

²¹⁹ "China undercuts sanctions on Iran", Barbara Slavin, Politico, June 2, 2011. <http://www.politico.com/news/stories/0611/56031.html>

²²⁰ Reuters, "Iran buys July gasoline from Turkey, Chinese sellers," July 8, 2010.

<http://in.reuters.com/article/2010/07/08/iran-gasoline-imports-idINLDE6671KD20100708>

²²¹ The Financial Times, "Deadlock over Iran oil and gas take toll," Najmeh Bozorgmehr, April 20, 2011.

²²² Reuters, "Tehran says Russia eyes gas swaps with Iran," November 1, 2008.

²²³ U.S. Energy Information Administration (EIA) - U.S. Dept. of Energy- U.S. Government, International Petroleum (Oil) Production Report, October, 2008.

²²⁴ IRNA, "Turkish Daily Says UN Fails in Anti-Gas Deal Attempts," September 28, 2007.

²²⁵ Pipeline and Gas Journal, "Pipeline Construction Scoreboard: Projects Planned and Under Construction," September 2008.

Georgian/Turkish (and/or the Iranian/Turkish border) and running to Austria, via Turkey, Bulgaria, Romania and Hungary.²²⁶

EU nations have been interested in the Nabucco project because it represents an opportunity for the EU to diversify its gas supply options and reduce its reliance on Russian gas imports, which in 2008 amounted to around 32% of their total demand.²²⁷ The deal has remained controversial, however, as a result of EU sanctions, and Nabucco Gas Pipeline International, due to what it calls “the current political situation,” decided not to plan a third pipeline to the Turkish-Iranian border as of 2011.²²⁸ Despite this setback for Iran, Nabucco is actively seeking new gas suppliers, which leaves the door open to future Iranian-Turkish energy cooperation.²²⁹

The end result is that influencing third country decisions to circumvent or ignore sanctions will remain an important part of US and Iranian competition. Iran still possesses enormous energy resources that will continue to be an attractive investment opportunity. The desire to build a lucrative foothold in Iranian energy may become a consideration for countries that are ambivalent about supporting Western regional influence in the future.

What is far less clear, however, is how Iran can avoid the impact of the growing sanctions on its banking industry and ability to carry out foreign currency transactions and trade. The action the EU took in cutting off Iran’s access to SWIFT, the actions the US took much earlier to restrict the access Iran’s banking industry and financial institutions had to world markets, and the prospects of much sharper US sanction during the course of 2012, all present problems for Iran where it has no clear solutions and interact with export and import sanctions by sharply restricting its ability to trade.

The Future Impacts of Sanctions

It is far too soon to determine just how much impact the new sanctions – and any additional sanctions that follow – will have on Iran. Long before new sanctions were put in place in late 2011 and early 2012, however, sanctions made it increasingly difficult for Iran to compete with other developing economies in international markets, put it at a disadvantage for attracting crucial foreign direct investment, and left the Iranian government unsure of how to confront the growing challenges.²³⁰

The Impact of Sanctions on the “Short Game”

Many economists and analysts agree that even the threat posed by the new sanctions have caused Iranian prices to rise and making it increasingly difficult for Iranian companies to work internationally.²³¹ Iran’s currency was already becoming far more unstable by late December 2010 —dropping in value to record lows —which led to increasingly haphazard attempts at government intervention. The Iranian Rial fell to a new low relative to world currencies in late

²²⁶ Parkinson, Joe, “Iran Sets Turkish Pipeline Project,” Wall Street Journal, July 24, 2010,

²²⁷ <http://www.pipelineandgasjournal.com/nabucco-pipeline-project-gas-bridge-europe>

²²⁸ <http://portal.nabucco-pipeline.com/portal/page/portal/en/NewsEdit/8E79E5BF557DCC2DE040A8C0010178CA>

²²⁹ Dow Jones Newswire, “RWE executive sees good progress on Nabucco gas supply deal,” Jan Hromadko, September 11, 2011. <http://online.wsj.com/article/BT-CO-20110913-704599.html>

²³⁰ Kevan Harris, “Iran’s new economic slump,” The Iran Primer, USIP, June 22, 2011.

<http://iranprimer.usip.org/blog/2011/jun/21/iran's-new-economic-slump>

²³¹ The Washington Post, “Sanctions begin to compound Iran’s severe economic problems”, Thomas Erdbrink, October 5, 2010. <http://www.washingtonpost.com/wp-dyn/content/article/2010/10/05/AR2010100505972.html>

January 2012, with a black market rate of 18,200 Rials to the dollar, compared with 11,000 to 12,000 as recently as December 2011, and a rate of 6,859 Rials in late July 2011.²³²

At the same time, virtually every transaction affecting imports and exports was affected by either the decline of the Rial or the uncertainties surrounding the willingness of non-US banks and firms to deal with Iran, given the threat of US sanctions or pressure from Europe and the Arab Southern Gulf states.

By early 2012, Iran's currency had lost approximately 35 percent of its value since September of 2011. As newly imposed sanctions began to take effect in January and February of 2012, the currency once artificially held high by Iranian government subsidies began to plummet as the Islamic regime could no longer bear the financial burden necessary to manipulate the market. According to CRS's February 2012 report on Iran Sanctions, "The payments process has become so difficult that Iran has begun to use gold and oil to pay for wheat and other imports".²³³

These developments are particularly important because existing sanctions had had an indirect impact on Iranian monetary policy as well. US sanctions on Iranian banks altered the availability of foreign currency before the new US and EU sanctions, and the exchange rate of the Iranian Rial has suffered in turn. On September 29, 2010, Iran's currency plummeted in value, and Iranian banks temporarily stopped the sale of Dollars and Euros.²³⁴ The Rial fell 22% against the dollar in its first major fluctuation in years.

The costs of trading with Iran had also risen substantially as a result of earlier US and UN sanctions. Costs associated with Iranian trade increased by an estimated 10% to 30%, according to outside figures.²³⁵ Official numbers from Iran's Trade Commission painted a less dramatic rise; nonetheless, but indicated that still concede that sanctions have slowed the pace of trade and increased trade costs for Iran between 5% and 10%.²³⁶

In his January 2012 Worldwide Threat Assessment, US Director of National Intelligence James Clapper stated that:²³⁷

Iran's economy is weighed down by international sanctions. The new US sanctions will have a greater impact on Iran than previous US designations because the Central Bank of Iran (CBI) is more important to Iran's international trade than any of the previously designated Iranian banks. The CBI has handled a greater volume of foreign bank transactions than other designated banks and receives the revenue for the roughly 70 percent of Iranian oil sold by the National Iranian Oil Company. ...

Despite this, Iran's economic difficulties probably will not jeopardize the regime, absent a sudden and sustained fall in oil prices or a sudden domestic crisis that disrupts oil exports. In a rare public indication of the sanctions' impact, Ahmadinejad said in a speech to the legislature in early November that Iran is facing

²³² <http://www.exchangerates.org.uk/USD-IRR-exchange-rate-history.html>; Rick Glasdton, "Iran's Currency at Low vs. Dollar, New York Times," January 19, 2012.

²³³ "Iran Sanctions", Kenneth Katz, CRS, February 10, 2012.

²³⁴ The Wall Street Journal, "Iran's Economy Feels Sting of Sanctions," Fassihi, Farnaz, October 12, 2010. <http://online.wsj.com/article/SB10001424052748703735804575535920875779114.html>

²³⁵ Rachel L. Loeffler, "Bank Shots," Foreign Affairs, April 2009. <http://www.foreignaffairs.com/articles/64822/rachel-l-loeffler/bank-shots>

²³⁶ Shayerah Ilias, "Iran's Economic Conditions: US Policy Issues," Congressional Research Service, April 22, 2010, <http://www.fas.org/sgp/crs/mideast/RL34525.pdf>

²³⁷ "Unclassified Statement for the Record on the Worldwide Threat Assessment of the US Intelligence Community for the Senate Select Committee on Intelligence", DNI James R. Clapper, January 31, 2012.

the “heaviest economic onslaught” in history, a sentiment echoed by the head of the CBI.” -DNI James Clapper

Since February 2012, the accumulated effects of strengthened international sanctions have damaged Iran’s economy in numerous ways. As broader sanctions increase in size and scope, Iran is losing business from both countries imposing sanctions, as well as those afraid of the risks of doing business with Iran. The loss of revenue from the EU, China, Japan, and South Korea accounts for 1 million of the 2.5 million barrels sold by Iran each day.²³⁸ Additionally, decreased trade and increasing inflation is leading to increased frustration among the Iranian public. Recent economic troubles have led business to downsize or close all together.

Figure V.13 shows other aspects of the interaction between sanctions and Iran’s self-inflicted economic problems. Furthermore, anecdotal and press reports suggest that many Iranians, particularly in the middle class were blaming the regime for economic difficulties brought about by the sanctions as well as the regime’s own economic missteps in early 2011. There have been similar reports of unrest among small and large merchants who were having trouble obtaining trade financing, insurance, and shipping availability, which was driving up their costs by an estimated 40%, if the merchants could complete desired transactions at all.²³⁹

What is clear is that the new sanctions have already had some impact, that this impact will grow steadily during 2011 and that over time, the new sanctions have a cumulative impact as Iran’s savings, holdings of foreign exchange, oil and gas export income, and the ability to fund imports are reduced. While they are not targeted at the Iranian people, they will also impact on every Iranian except the tiny number farming at the subsistence level, and will do so in an economy where savings and investment have been hurt by inflation and mismanagement over decades. The new series of sanctions is certain to have a growing impact on every Iranian whose income is shaped by the market economy – the vast majority in a country that the World Bank and CIA estimate is 67% to 71% urbanized.

It does seem likely, therefore, that the new sanctions will produce a major economic crisis for Iran by the fall of 2012 unless Iran does more than simply negotiate, threaten, and posture. Iran’s leadership may be able to persevere in spite of such pressures, but this is also uncertain. Past polls and election results are one thing, popular discontent after the new sanctions combine with old may be a different story.

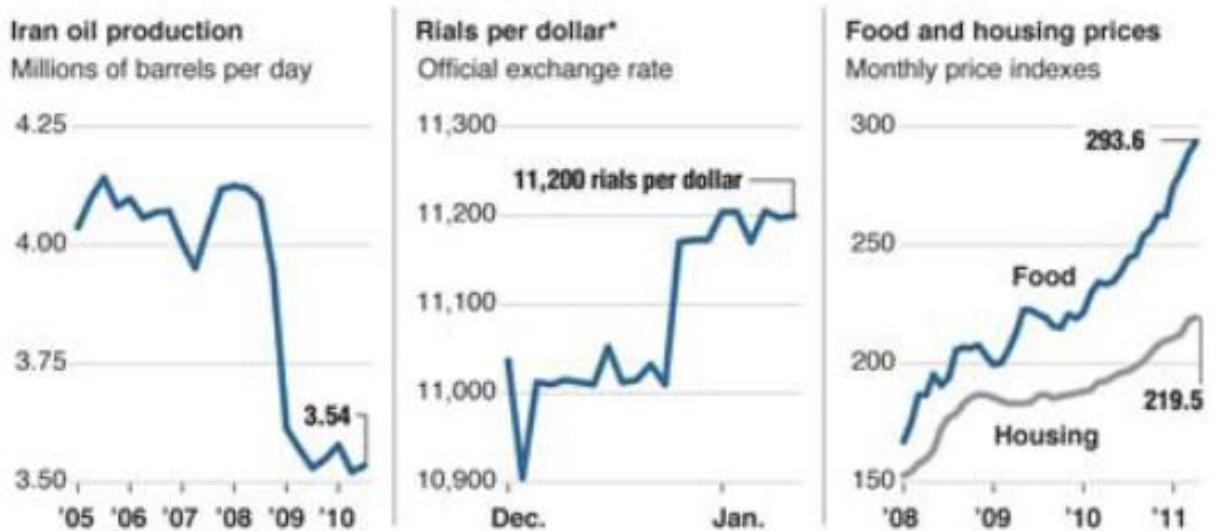
It is also important to note, however, that the “hardliners” in the regime have become steadily more divided, and sanctions are now biting much harder. Iranians cannot avoid seeing the deep differences within the clergy, the growing role of the unelected leaders of the IRGC, and the bitter exchanges between the factions led by the Supreme Leader Ali Khamenei and the President Mahmoud Ahmadinejad. Iran’s history of corrupt presidential and legislative elections, crackdowns on human rights do not help, and the more that sanctions interact with repressive religious restrictions on normal life, the more these problems are likely to impact on all classes of Iranian society.

²³⁸ “Iran Sanctions”, Kenneth Katz, Congressional Research Service, February 10, 2012.

²³⁹ The Associated Press, “Iran’s Gateway in Dubai Highlights Sanctions Bite,” Brian Murphy, February 1, 2011. <http://abcnews.go.com/Business/wireStory?id=12808709>

Figure V.13: The Growing Pressure on Iran

Iran's oil production is falling, its currency weakening and inflation rising. The U.S. would like to see Iran but hopes to limit the number of customers, so they can demand discounts and further cut revenue to 7



*On the open market, the exchange rate for Iran's rial was 17,800 rials per dollar on Jan. 2.

Source: Bloomberg News, Iran Central Bank, U.S. Energy Information Administration

Graphic: Scott J. Wilson, Wil Ramirez, Robert E

Source: Adapted from Chicago Tribune web site, http://www.chicagotribune.com/news/nationworld/sns-graphics-sanctions-hurting-iran-gx,0,3011693_graphic.

The Risks in a “Long Game”

So far, Iran seems to have backed away from any military confrontation, but it is far less clear what will happen if sanctions result in a prolonged confrontation or “long game.” It has at least as much to lose as any other Gulf state if it has to halt its oil exports and imports through the Gulf. It also cannot hope to win any serious conflict with the US and its Southern Gulf allies and could take devastating losses if the US escalated its strikes beyond the Gulf and the Iranian forces directly involved in a clash or conflict.

Iran can, however, put a wide range of less serious pressures on the follow of oil. As **Figure 4.14** shows, Iran's threats and exercises helped raise crude oil prices during December 2011 and January 2012, but scarcely to new levels or ones that had a major practical impact on the US and other developed economies.²⁴⁰ Low level attacks, floating mines, new exercises, and other measures could put prolonged pressures on shipping costs. Saudi Arabia and other oil exporting states might have serious problems in compensating for cuts in Iranian oil exports if the confrontation lasted long enough for the world economy (and petroleum demand) to recover. The threat of far more serious Iranian escalation could be used to put pressure on oil prices without actual Iranian attacks, and no one can dismiss the possibility that a desperate Iranian regime might escalate that disrupted world oil prices for at least several weeks.

²⁴⁰ The EIA shows a far more serious surge in US short-term gasoline and crude oil prices in the spring of 2011 – driven by market forces – than during the period from September 2011 to late January 2012. See the graphs in EIA, “Petroleum and Other Liquids,” <http://www.eia.gov/petroleum/>, accessed January 21, 2012.

A period of confrontation and sanctions that lasted for several years would give Iran time to steadily improve its options and tactics for asymmetric attacks and political warfare, and evidence that Iran actually had a nuclear weapon might both lead many nations to abandon sanctions and make the credibility of US, European, and Southern Gulf escalation major conflicts and strikes on Iran less credible.

Iran would take risks of its own, and it has no inherent advantages in playing the “long game.” Most such Iranian action would inevitably strengthen US, European, and Southern Gulf resolve, and support for sanctions. Iran would pay a steadily higher cumulative cost as a result of sanctions over time, and popular support for the regime might well erode. Iran cannot be certain it can ever use lower level asymmetric tactics without provoking the US and other states to escalate to much higher levels of conflict, or be certain it can control the course of events and the risk of some incident leading to higher levels of conflict.

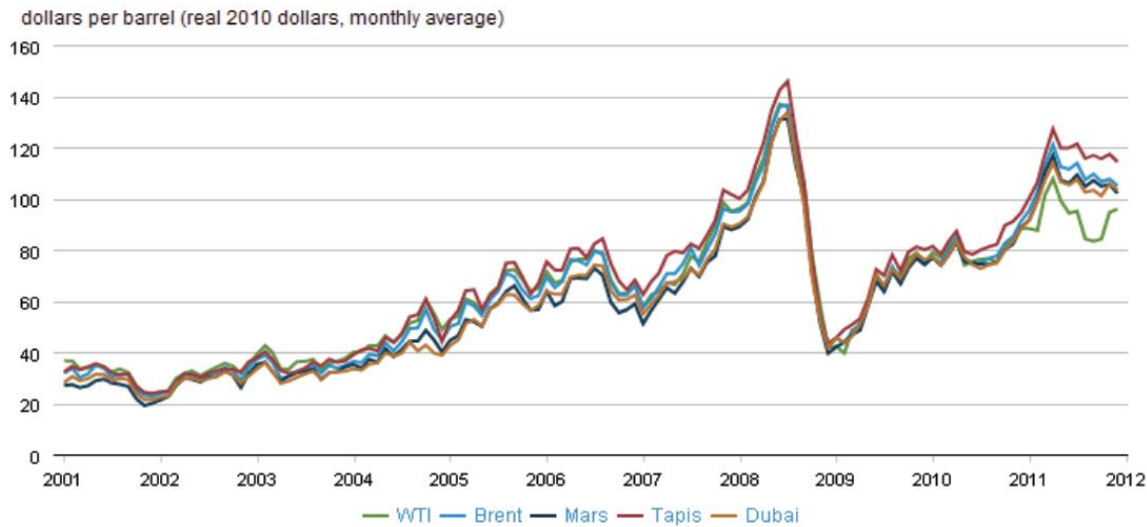
Israel may find it harder and harder to conduct a preventive strike over time against Iran as Iran disperses and hardens its facilities, and if it eventually deploys nuclear weapons. However, Israel has far more near and mid-term options to improve its nuclear forces, and nuclear delivery options than Iran, and Iran has already pushed Israel into extending the range-payload of its missiles and examining options like submarine delivered nuclear weapons. While Iran can improve its asymmetric forces and move forward in developing nascent nuclear forces, nations like Saudi Arabia and the UAE have already begun to build up their conventional strike and defense capabilities at far faster rates than Iran, and Iran cannot dismiss the possibility it will provoke the US into some form of clear commitment to “extended deterrence” or Saudi Arabia into pursuing its own nuclear option. Iran would also risk Israel or the US turning to preventive military options as sanctions failed to have their desired effect, and doing so with growing support from Iran’s neighbors.

At a different level, Iran would risk shifts in investment and energy developments that favored other exporters, ranging from oil and gas development to pipelines and export facilities. High prices would favor the Arab Gulf states as long as they had much greater freedom to invest and export, they would have no reason to support Iran in OPEC, and they would face fewer restrictions on their arms imports. In the short to mid-term, Iran might see its oil and gas export capacity drop because it could not get the technology and capital it needs, or its costs rise per unit of actual production. In the long run, Iran’s impact in creating sustained high price pressures might favor competition from gas fracturing and alternative liquids.

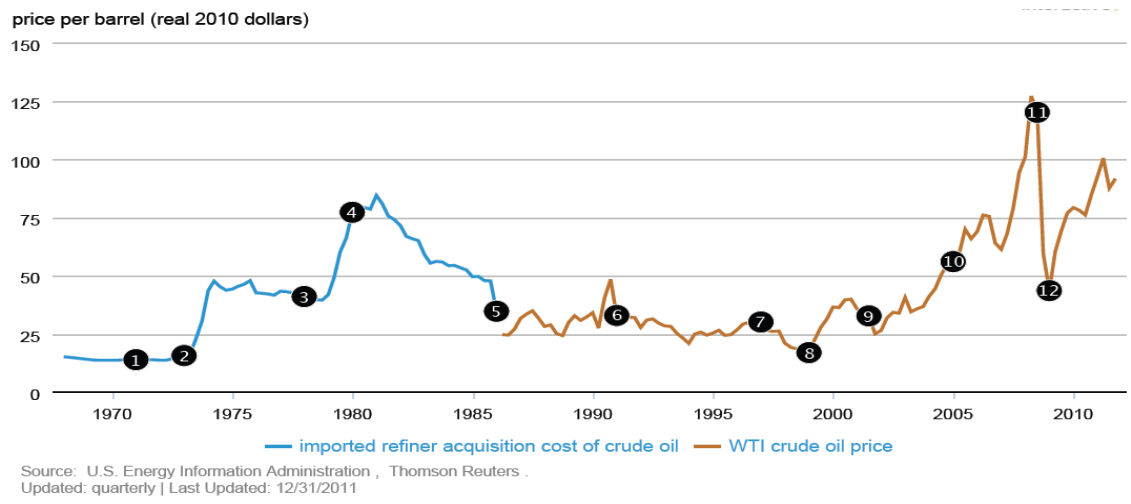
The other side of the coin is what happens if --and after -- Iran tests a nuclear device or makes claims to have one that US, other Western, Arab, and Israeli intelligence experts accept. Pakistan, North Korea, and India are all cases where major political efforts to halt their nuclear programs faded quickly after their nuclear capability became a fact, and the world ended in de facto acceptance. This may not be the case for Iran, but Iran is certainly aware that other states have not only won the “long game,” but eventually benefited from it in terms of both regional power and influence and the ability to use nuclear capability as leverage in dealing with their neighbors and even the US. In contrast, a Libya whose regime gave up weapons of mass destruction is an example of exactly the opposite kind.

Figure V.14: Trends in Oil Prices

World Prices Did Rise as a Result of Iran’s Recent Threats



But Crises, Weather, Speculation, and Economic Pressures Have Also Led to Massive Swings in the Past



- | | |
|---------------------------------------|--|
| 1: US spare capacity exhausted | 7: Asian financial crisis |
| 2: Arab Oil Embargo | 8: OPEC cuts production targets 1.7 mmbpd |
| 3: Iranian Revolution | 9: 9-11 attacks |
| 4: Iran-Iraq War | 10: Low spare capacity |
| 5: Saudis abandon swing producer role | 11: Global financial collapse |
| 6: Iraq invades Kuwait | 12: OPEC cuts production targets 4.2 mmbpd |

Source: EIA, What Drives Oil Prices, January 21, http://www.eia.gov/finance/markets/spot_prices.cfm

Sanctions and Arms Deals

As has been touched upon in Chapter III, arms sales are another way in which Iran and the US are competing in the Middle East. Although it can be argued that this is simply another form of military competition, the US and its allies make use of the Nuclear Non-Proliferation Treaty, the

inspection and reporting role of the International Atomic Energy Agency (IAEA), arms control treaties like the CWC, and conventions affecting the transfer of missiles with ranges above 300 kilometers (MTCR) to try and halt Iran's efforts to acquire nuclear armed missiles and other weapons of mass destruction.

The United States has pursued a two-pronged approach to controlling the balance of military power in the region. Resolution 1929 prohibits the sale to Iran of, "any battle tanks, armored combat vehicles, large caliber artillery systems, combat aircraft, attack helicopters, warships, missiles or missile systems or related materiel, including spare parts."²⁴¹

In addition to banning Iran's acquisition of nearly all major conventional weapons systems, the US has transferred weapons and technology to its Gulf Allies. Between 2005 and 2009, the United States sold nearly \$37 billion worth of weapons and military equipment to Gulf nations, including Saudi Arabia, the United Arab Emirates (UAE), Bahrain, Qatar, Oman, and Kuwait.²⁴² In 2010, the United States negotiated a \$20 billion arms package with a number of Gulf States as part of the Gulf Security Dialogue. Later that year, Saudi Arabia alone finalized an enormous arms deal with the United States that will total more than \$60 billion over the next 10 years.²⁴³

Iran responded by turning to Russia and China in order to purchase military hardware shortly after the fall of the Shah and the beginning of the Iran-Iraq War in 1980. Since 1992, Russia has sold Iran hundreds of major weapons systems, including T-72 tanks, Tor-M1 missile systems, and a handful of combat aircraft like the MiG-29 and SU-24.^{244,245} The two countries signed a nearly \$1 billion deal in 2007 to supply Iran with five batteries of long-range S-300 air-defense missiles, which are similar to the US Patriot system.²⁴⁶ The S-300 system was a high priority for Tehran because it would increase their ability to defend their nuclear installations from attack.

The Russians, however, have begun to respond to international pressure to isolate Tehran. Russia delayed its delivery of the S-300 system in 2009 amid the "diplomatic reset" with the United States. After Russia voted in favor of the latest round of UN sanctions in 2010, officially canceled the project and barred all future sale of sophisticated weapons to Iran.²⁴⁷ Russian Foreign Minister Sergei Lavrov said, "there are fundamental principles linked to the sale that we never, in accordance with our legislation, and according to our international obligations, take any actions that will lead to the destabilization of certain regions."²⁴⁸

²⁴¹ UN Department of Public Information, "Security Council Imposes New Sanctions on Iran," June 9, 2010. <http://www.un.org/News/Press/docs/2010/sc9948.doc.htm>

²⁴² Christian Science Monitor, "How Arms Deals are Shaping the Mideast," Kristen Chick, October 6, 2010, <http://www.csmonitor.com/World/Middle-East/2010/1006/How-arms-deals-are-shaping-the-Mideast>

²⁴³ Christian Science Monitor, "Blockbuster US Arms Sale to Saudi Arabia: Will it Deter Iran?" Anne Mulrine, September 21, 2010. <http://www.csmonitor.com/USA/Military/2010/0921/Blockbuster-US-arms-sale-to-Saudi-Arabia-Will-it-deter-Iran>

²⁴⁴ Lionel Beehner, "Russia-Iran Arms Trade," Council on Foreign Relations, November 1, 2006. <http://www.cfr.org/iran/russia-iran-arms-trade/p11869>

²⁴⁵ The Times UK, "Russia Ratchets up US tensions with arms sales to Iran and Venezuela," Tony Halpin, September 19, 2008. <http://www.timesonline.co.uk/tol/news/world/europe/article4781027.ece>

²⁴⁶ Christian Science Monitor, "Why Russia is cutting off major arms sales to Iran," Fred Weir, September 23, 2010. <http://www.csmonitor.com/World/Europe/2010/0923/Why-Russia-is-cutting-off-major-arms-sales-to-Iran>

²⁴⁷ Christian Science Monitor, "Why Russia is Cutting Off Major Arms Sales to Iran," Fred Weir, September 23, 2010

²⁴⁸ The New York Times, "Russia Links Iran Arms Sale to Regional Tensions," February 24, 2010.

Supplying weapons to Iran was also beginning to hinder Russia's ability to upgrade its domestic military capability and purchase top-of-the-line arms from Western countries. Russia closed a deal in 2009 to purchase unmanned aerial vehicles from Israel,²⁴⁹ and reached a \$1.52 billion deal in 2011 for Paris to supply them with two Mistral class helicopter carriers. These were Moscow's first major foreign arms purchases in the two decades since the fall of the Soviet Union.²⁵⁰

Moscow may currently value its relationship with its Western arms and technology suppliers more than its weapons trade with Iran. The Russian Ministry of Defense is also hoping that displaying restraint with Tehran will convince Israel not to resume weapon sales to Georgia, which it discontinued, at Moscow's request, after the outbreak of the 2008 Russia-Georgia conflict.²⁵¹ In any case, the estimate value of new arms transfer agreements between Iran and Russia dropped from \$2,100 million in 2001-2006 to \$300 million in 2007-2010.²⁵²

China, on the other hand, has been a consistent supplier of conventional weapons to Iran, although it has largely complied with the Missile Technology control Regime and limits on the export of nuclear-related technology. Dr. Bates Gill wrote in 1998 that "with the exception of Pakistan and possibly North Korea, China's arms trade with Iran has been more quantitatively and qualitatively comprehensive and sustained than that with any other country."²⁵³

The volume of such traffic has dropped over time. China made over \$3 billion in arms transfer agreements with Iran from 1980-1987, supplied \$400 million worth of weapons from 1993-1996, \$600 million from 1997-2000, \$300 million between 2001 and 2006, and less than \$50 million between 2007 and 2010.²⁵⁴

As talks stalled with Russia over delivery of the S-300 missile system, Iran reportedly looked to China, which had recently put a replica of the S-300 on the export market.²⁵⁵ The US, however, has consistently opposed Chinese military sales to Iran. Speaking with CNN in 2007, Under Secretary of State for Political Affairs Nicolas Burns pointedly stated that the US has "irrefutable evidence" that the Iranians were transferring arms to militants in "Lebanon, in Gaza, in Afghanistan, and in Iraq" in direct contravention of UN Security Council Resolution 1747, which bans Iranian arms exports.²⁵⁶ John McConnell, the former Director of National

²⁴⁹ United Press International, "Russia, Israel sign spy drone deal," April 10, 2009.

http://www.upi.com/Top_News/2009/04/10/Russia-Israel-sign-spy-drone-deal/UPI-52871239374884/

²⁵⁰ Reuters, "Russia, France sign Mistral helicopter deal," Alexei Anischuk, June 17, 2011.

<http://www.reuters.com/article/2011/06/17/russia-france-mistral-idUSLDE75G1K520110617>

²⁵¹ Mark Katz, "Iran and Russia," The Iran Primer, USIP, December 2010.

<http://iranprimer.usip.org/resource/iran-and-russia>

²⁵² Richard F. Grimmett, "Conventional Arms Transfers to Developing Nations, 1993-2000," Congressional Research Service, August 2001, p. 28; and Richard F. Grimmett, "Conventional Arms Transfers to Developing Nations, 203-210," Congressional Research Service, August 2001, pp. 43-44.

²⁵³ Bates Gill, "Chinese Arms Exports to Iran," Middle East Review of International Affairs, Vol. 2, No. 2 (May 1998), 57.

²⁵⁴ Richard F. Grimmett, "Conventional Arms Transfers to Developing Nations, 1993-2000," Congressional Research Service, August 2001, p. 28; and Richard F. Grimmett, "Conventional Arms Transfers to Developing Nations, 203-210," Congressional Research Service, August 2001, pp. 43-44.

²⁵⁵ Iranian Press TV, "Russia 'Losing to China on Iran S-300 Quest,'" May 9, 2009.

<http://edition.presstv.ir/detail/94183.html>

²⁵⁶ CNN, "Iran arming Taliban, US claims," June 13, 2007.

<http://edition.cnn.com/2007/WORLD/asiapcf/06/13/iran.taliban/index.html>

Intelligence, testified to Congress that the PRC's arms sales in the Middle East were "destabilizing" and "a threat" to US forces.²⁵⁷

Faced with sanctions tightening its arms procurement abilities, Iran has begun investing in a nascent domestic defense industry. When the S-300 sale fell through, the Iranian military announced that it would upgrade existing S-200 systems to such a degree that they would be superior to the modern, Russian built technology.²⁵⁸

General Seyed Reza Taheri boasted in July 2011—with limited credibility and realism—that:

The air defense systems' operational speed and range have been promoted thanks to the attempts made by our country's experts. We are witnessing a jump in this field when considering the previous models."²⁵⁹ Iran may be able to develop a more robust arms development capability in the medium to long term, but their domestic capability in the near future is fairly limited. Iranian weapons developers focus primarily on modifying older technology and are therefore still heavily reliant on weapons imports.²⁶⁰

Iran has made some progress. Theodore Karasik, a regional affairs expert at the Dubai-based Institute for Near East and Gulf Military Analysis, has said, "compared with five or 10 years ago, Iran seems to have made significant strides. They probably aren't fully self-sufficient for defense needs, but they are moving in that direction."²⁶¹

As Chapters III and IV have shown, however, Iran has a long way to go, and the new sanctions may have a major impact on the extent to which Iran can fund critical imports of arms, munitions, military spare parts, military production equipment, and other technology. There are no reliable figures on the size of either Iran's total military-related imports – since so much dual use technology is imported and so many imports are disguised under false names or licenses. There are no meaningful public estimates of Iran's current military spending because the reporting of the state sector expenditures on almost every aspect of security is so distorted and cloaked for security reasons. US experts tentatively put the 2011 level at "well over" \$10 billion a year, but state this is little more than a guesstimate.

Similarly, work by Richard F. Grimmett of US Congressional Research Service estimates Iranian arms imports at \$700 million in current dollars from 2007-2010, as opposed to \$ 800 million in 2003-2006. He also estimates Iran's new arms agreements at a cripplingly low \$700 million in 2007-2010, compared with \$2,700 million in 2003-2006. These totals do not include major amounts of nuclear, dual use, military production-related, and "black" hidden imports; but they show that Iran's new arms transfer agreements can only give it a fraction of the arms transfers of the Arab Gulf states, and far too few imports to modernize and sustain its forces long before the new round of sanctions went into effect.²⁶²

²⁵⁷ Shirley Kan, "US-China Counter-Terrorism Cooperation: Issues for US Policy," Congressional Research Service, July 15, 2010. 36.

²⁵⁸ Fars News Agency, "Iran to develop new generation of S-200 air-defense missiles," November 14, 2010. <http://english.farsnews.com/newstext.php?nn=8908231551>

²⁵⁹ Ibid

²⁶⁰ Associated Press, "Iran showcases homegrown arms in war games," Ali Akbar Dareini, July 5, 2011. <http://news.yahoo.com/iran-showcases-homegrown-arms-war-games-102403551.html>

²⁶¹ Ibid

²⁶² Richard F. Grimmett, *Conventional Arms Transfers to Developing Nations, 2003-2010*, Congressional Research Service, R-42017, Washington, DC. September 22, 2011 pp. 43-44, 75-58

Another key uncertainty is just how much the impact of the new sanctions will affect the Iranian people and their attitudes towards the regime and the states that impose such sanctions. Iran faces many other long-standing economic problems, including major barriers to efficient investment, massive youth unemployment, and inflationary cycles. It must also deal with an uncertain transition out of government-funded subsidies.

The impact of new sanctions will add to all of these problems, and much of the burden will fall on the Iranian people. The full impact of this burden, and its domestic implications, will not become clear until after mid 2012. It is clear from Iranian media, however, the people are as aware as the government that sanctions are having a steadily more significant effect on Iran's ability to interact with international financial institutions and increased the diplomatic costs for Tehran's trading partners. Irrespective of whether the Iranian economy is "crippled," sanctions clearly do function as a strategic tool in putting pressure on Iran, and have further isolated Iran in the international arena.

Arms Control: Iran, Israel, and the WMD Free Zone

Arms control is another aspect of US and Iranian diplomatic competition which is tied to both the military developments described in Chapters III and IV, and to the negotiating leverage that sanctions and US military strengthen in the Gulf can apply. The US and other members of the 5+1 have long sought to use both sanctions and arms control to limit Iran's nuclear programs. Iran, in turn, has seen a WMD Free Zone in the Middle East as a way of putting pressure on the US and Israel, gaining Arab support, and limiting Arab pressure on Iran over Iran's nuclear programs.

Efforts to Negotiate with Iran

While the US and Israel have both stated in different ways that Iran must not be allowed to have nuclear weapons, no state has announced fixed "red lines" that would trigger preventive attacks, and "unacceptable" has been a distinctly relative term that has evolved over time. It is also clear that any limits that Iran agrees to as a result of sanction and negotiations must be tied to some form of arms control protocol and verification arrangement based on the capabilities Iran has at the time of the actual agreement, and can acquire in the future.

The history of past negotiations is complex, but the Arms Control Association has developed an excellent summary history that shows the pattern of negotiations to date. This history is shown in **Figure V.15:**

Figure V.15: Arms Control Association History of Official Proposals on the Iranian Nuclear Issue.

Spring 2003 Proposal

According to Tim Guldemann, former Swiss ambassador to Tehran, Iran issued a proposal to the United States in May 2003 calling for negotiations on a variety of contentious issues between the two countries. The document listed a number of agenda items that the two countries would negotiate and proposed the creation of three parallel working groups to carry out negotiations on disarmament, regional security, and economic cooperation. Key among the agenda items were:

- Relief of all U.S. sanctions on Iran
- Cooperation to stabilize Iraq
- Full transparency over Iran's nuclear program, including the Additional Protocol

- Cooperation against terrorist organizations, particularly the Mujahedin-e Khalq and al-Qaeda
- Iran's acceptance of the Arab League's 2002 "land for peace" declaration on Israel/Palestine
- Iran's full access to peaceful nuclear technology, as well as chemical and bio-technology

The Bush administration dismissed the proposal in favor of placing additional pressure on Iran.

EU3-Iran Proposals

Several months later, France, Germany, and the United Kingdom agreed to discuss with Iran a range of nuclear, security, and economic issues as long as Tehran suspended work on its uranium enrichment program and cooperated fully with an investigation by the International Atomic Energy Agency (IAEA). However, that agreement unraveled the following year when Tehran continued work on uranium conversion, the precursor to enrichment. Iran then agreed with the EU3 in November 2004 to implement a more stringent suspension. Negotiations between the two sides began shortly afterward.

Iran presented four proposals during the course of these negotiations. In addition to Iran's nuclear program, the proposals covered subjects such as Tehran's support for terrorist organizations, regional security issues, and economic cooperation.

The Iranian proposals were as follows:

January 17, 2005 This Iranian proposal to the EU3/Iran Political and Security Working Group outlined commitments on both sides in general terms, including:

- An Iranian commitment not to pursue weapons of mass destruction
- A rejection of any attacks, threats of attack, or sabotage of Iran's nuclear facilities
- Cooperation on combating terrorism, including intensifying the exchange of information and the denial of safe havens
- Regional security cooperation, including on Iraq and Afghanistan
- Cooperation on strategic trade controls and the EU removal of restrictions on transfers of conventional arms and dual use goods to Iran

March 23, 2005

The Iranian proposal to the EU3/Iran steering committee in March provided greater detail into the "objective guarantees" Iran was willing to discuss regarding its nuclear program, including:

- Iran's adoption of the IAEA Additional Protocol and continuous on-site inspections at key facilities
- Limiting the expansion of Iran's enrichment program and a policy declaration of no reprocessing
- Immediately converting all enriched uranium to fuel rods
- An EU declaration recognizing Iran as a major source of energy for Europe
- Iran's guaranteed access to advanced nuclear technology along with contracts for the construction of nuclear plants in Iran by the EU
- Normalizing Iran's status under G8 export controls

April 29, 2005

In April Iran's proposal repeated some of the items in the March proposal, but focused more on short-term confidence-building measures than long term resolutions. Its key terms included:

- Iran's adoption of the IAEA Additional Protocol
- A policy declaration of no reprocessing by Iran

- Continued enrichment suspension for six months
- Establishment of joint task forces on counter-terrorism and export control
- An EU declaration recognizing Iran as a major source of energy for Europe

July 18, 2005

Iranian Message from Hassan Rowhani, then-Secretary of Iran's Supreme National Security Council, to France, Germany, and the United Kingdom. In his statement Rohani proposes:

- An agreement on initial limitations on uranium enrichment at Natanz
- Negotiations for the full-scale operation of Natanz
- Arrangements to import material for uranium conversion and the export of UF₆
- Negotiation of an "optimized" IAEA monitoring mechanism for Natanz

In August 2005 the three European countries presented their own comprehensive proposal for a long-term agreement, outlining the following:

- Arrangements for the assured supply of low enriched uranium for any light water reactors constructed in Iran
- Establishing a buffer store of nuclear fuel located in a third country
- A commitment by Iran not to pursue fuel cycle technologies, reviewable after 10 years
- A legally binding commitment by Iran not to withdraw from the NPT and Iran's adoption of the Additional Protocol
- Arrangements for Iran to return spent nuclear fuel to supplier countries
- EU recognition of Iran as a long-term source of fossil fuel energy
- EU-Iran cooperation in a variety of political-security areas, including Iraq and Afghanistan, terrorism, and drug trafficking

Iran rejected that proposal days later, claiming that it did not recognize Iran's right to enrichment. Tehran proceeded with uranium conversion, breaking the suspension agreement with the EU3 and ending negotiations.

In order to support Iran's talks with the EU, Russia proposed to Iran in October 2005 that Tehran share ownership of a uranium-enrichment plant located in Russia. Following months of discussions on that proposal, Iran ultimately rejected it in March 2006.

P5+1 Proposals

China, Russia, and the United States joined the three EU3 countries in June 2006 to offer another proposal for comprehensive negotiations with Iran. The proposal mirrored some of the previous offers for negotiations and included the following key points:

- Iran's suspension of enrichment-related and reprocessing activities
- The establishment of a mechanism to review this moratorium
- Iran's resumption of the Additional Protocol
- The provision of state-of-the-art light water reactors to Iran through joint projects, along with nuclear fuel guarantees and a 5-year buffer stock of fuel
- Suspension of the discussion of Iran's nuclear program in the UN Security Council

- Cooperation on civil aviation, telecommunications, high-technology, and agriculture, and other areas, between the United States, EU, and Iran

Tehran responded to this proposal in August 2006. It rejected the terms of the proposal due to its requirement that Iran suspend its enrichment-related activities, but noted that the proposal contained “useful foundations and capacities for comprehensive and long-term cooperation between the two sides.” It did not, however, identify what those useful foundations were.

In March 2008, the P5+1 agreed to “repackage” the June 2006 proposal in order to specify some of the benefits that they would offer Iran as part of a long-term agreement on its nuclear program and to better demonstrate the nature of those benefits to the Iranian public. This agreement to revise the 2006 proposal coincided with the adoption of Security Council Resolution 1803, the third UN sanctions resolution on Iran.

Before that package was formally submitted to Iran, however, Tehran issued its own proposal to the six-country group. While the Iranian proposal also called for comprehensive negotiations leading to cooperation on nuclear energy, and political and economic concerns, it offered very few details regarding the steps Iran would take to resolve concerns related to its nuclear program. Some of its key provisions were:

- “Establishing enrichment and nuclear fuel production consortiums in different parts of the world-including Iran”
- Improved IAEA supervision “in different states”
- Cooperation on nuclear safety and physical protection
- Cooperation on export controls
- Cooperation on regional security and global economic issues

The P5+1 group presented their revised package during a June 2008 meeting in Tehran which included participants from five of the six countries, excluding the United States. During the meeting, the six-countries relayed an understanding that preliminary talks could begin under a six-week “freeze-for-freeze” period in which Iran would halt the expansion of its enrichment program while the six countries would agree not to pursue additional sanctions against Tehran. The proposal also entailed:

- The 2006 package remains on the table
- Consideration of nuclear energy R&D and treatment of Iran’s nuclear program as any other NPT non-nuclear-weapons state once confidence is restored
- Technological and financial assistance for Iran’s nuclear energy program
- Reaffirmation of the UN Charter obligation to refrain from the use and threat of use of force in a manner inconsistent with the Charter
- Cooperation on Afghanistan, including drug-trafficking, refugee return, reconstruction, and border controls
- Steps towards normalizing economic and trade relations, including support for WTO membership for Iran
- Further details on the prospect for cooperation on agriculture, the environment and infrastructure, civil aviation, and social development and humanitarian issues

Representatives of the six-country group, including the United States for the first time, followed up the June meeting with a meeting in July 2008 in Geneva. At the meeting, Iran issued a non-paper proposing a process for negotiations, highlighting that such discussions would be “based on the commonalities of the two packages” issued by Iran and the P5+1 group in May and June. Both the P5+1 and Iranian proposals called for political, economic, and security cooperation but the Iranian proposal did not address steps that Tehran would take in regard to its nuclear program. The Geneva discussions were inconclusive.

Following the election of U.S. President Barack Obama, who sought to abandon the previous U.S. policy requiring Iran to fulfill UN Security Council demands to suspend nuclear fuel cycle activities prior to negotiations, the P5+1 sought to renew their negotiations with Iran. They issued a statement in April 2009 in which the other five countries welcomed “the new direction of U.S. policy towards Iran,” formally inviting Iran to talks once again.

Iran did not respond to that invitation until that September, when Tehran issued a revised proposal. Although that proposal repeated several of the provisions of the one Iran issued in 2008, it did not include a section on the nuclear issue. Instead, the proposal covered the following:

- Cooperation to address terrorism, drug trafficking, organized crime, and piracy
- UN and Security Council reform
- The codification of rights for the use of space
- Promoting a “rule-based” and “equitable” IAEA oversight function
- Promoting NPT universality and WMD nonproliferation

Tehran Research Reactor “Fuel Swap” Proposal

In June 2009, Iran informed the IAEA that it was seeking assistance to refuel its Tehran Research Reactor (TRR), a U.S.-supplied 5 megawatt research reactor that produces medical isotopes. Following Iran’s entreaty, the United States proposed that, in return for a supply of 120 kilograms of fuel for the TRR, Iran ship out an equivalent amount of uranium enriched to 4%, totaling about 1,200 kilograms. The 1,200 kilograms accounted for roughly 80% of Iran’s LEU stockpile at that time, a percentage that diminished as Iran continued to produce LEU. At an initial meeting between the United States, France, Russia, Iran, and the IAEA October 1, 2009, Iranian officials agreed “in principle” to the exchange.

- Iran exports 1,200 kilograms of LEU in a single batch before the end of the 2009
- Russia further enriches Iran’s LEU to about 20%, a process producing about 120 kilograms of 20%-enriched uranium for the TRR fuel rods
- France manufactures the TRR fuel rods for delivery about one year after the conclusion of the agreement, prior to the depletion of the current TRR fuel supply
- The United States works with the IAEA to improve safety and control implementation at the TRR

Following reservations expressed by Iran about the terms of the deal, the P5+1 indicated their readiness to take some steps to facilitate the arrangement:

- A political statement of support by the six countries to guarantee that the TRR fuel would be delivered to Iran
- Financing for the movement of LEU and fuel
- An option for the IAEA to hold Iran’s LEU in escrow in a third country until the TRR fuel is delivered

In the months following the initial agreement of the TRR proposal Oct.1, Iran delayed giving the IAEA and the P5+1 a definitive response to the proposal, with many prominent Iranian politicians voicing their opposition to the arrangement, motivated at least in part by their opposition to President Ahmadinejad. Iranian officials publicly suggested alterations to the fuel swap proposal, including: staggering the export of Iran’s LEU over the course of a year or transporting 400 kilograms of LEU to Iran’s Kish Island to exchange for TRR fuel. These proposals, however, undermined or eliminated the confidence-building nature of the export of the bulk of Iran’s LEU. Tehran began to increase the enrichment level of some of its LEU to 20% in February 2010, ostensibly for TRR fuel.

Brazil, Turkey, Iran Tehran Declaration

Brazil and Turkey carried out a diplomatic initiative in the Spring of 2010 to broker the TRR fuel swap with Iran. In an April 20 letter to the leaders of the two countries, President Obama said Iran’s agreement to export 1,200 kilograms of LEU “would build confidence and reduce regional tensions by substantially reducing Iran’s LEU stockpile.” The initiative resulted in the May 17 Tehran Declaration agreed between Presidents Lula da Silva, Erdogan, and Ahmadinejad.

- The three countries “recall the right of all State Parties, including the Islamic Republic of Iran, to develop research, production and use of nuclear energy (as well as nuclear fuel cycle including enrichment activities)”

- Iran transfers 1,200 kilograms of LEU to be held in escrow in Turkey within one month
- Pending their approval of the Tehran Declaration, the IAEA, France, Russia, and the United States (the Vienna Group) would agree to provide 120 kilograms of 20%-enriched uranium fuel to Iran within one year
- If the terms were not filled by the Vienna Group, Turkey would transfer the LEU back to Iran (which maintains legal possession of the material)

France, Russia, and the United States rejected the Tehran Declaration on a number of grounds identified in a June 9 letter to IAEA Director General Yukiya Amano. The key critique was that the declaration did not address Iran's production of 20%-enriched uranium and Iran's accumulation of a larger amount of LEU.

Russian Step-by-Step Proposal

Russian Foreign Minister Sergei Lavrov first publicly proposed a "road map" to implement the P5+1's proposed incentives package July 12 during a speech in Washington. The specific details of the plan have not been made public, but they have been characterized as a "step-by-step" process in which confidence-building and transparency measures taken by Iran are met with an easing of sanctions by the P5+1.

- Each side takes a series of reciprocal actions in four stages
- Iran initially freezes the expansion of its enrichment program and limits enrichment to 5%
- Iran gradually provides greater IAEA access to its nuclear program
- Iran ultimately suspends enrichment for 3 months
- The P5+1 gradually lifts UN sanctions
- The P5+1 each gradually lift unilateral sanctions
- The P5+1 implement the incentives identified in their 2006 and 2008 proposals

Other P5+1 members have not voiced public opposition to the Russian proposal, but some do not appear to support it in its current form. U.S. officials have said that Washington is studying the proposal, and have held meetings with Moscow regarding the plan. Similarly, Iran publicly welcomed the proposal but has been non-committal regarding its terms, claiming it would take several months to study.

Source: Arms Control Association, "History of Official Proposals on the Iranian Nuclear Issue," *Contact*: Peter Crail, Research Analyst, (202) 463-8270 x102, <http://www.armscontrol.org/print/2570>

As **Figure V.15** shows, each major step in Iran's nuclear and missile progress – or the discovery of efforts Iran attempt to conceal – has tended to make some aspects of earlier arms control proposals obsolete. This does not mean, however, that the NNPT is ineffective or that the IAEA cannot produce credible verification if past agreements are updated and tailored to the circumstances that exist at the time. Groups like the Arms Control Association and ISIS have shown that there are still realistic options for Iran's compliance.²⁶³ Moreover, Iran agreed to negotiate with the 5+1 in March 2012, and this at least provides some opportunity to update past proposals and make them more effective.

²⁶³ For an excellent analysis of the trade-offs, risks, and cost-benefits involved see David Albright, Paul Brannan, Andrea Stricker, Christina Walrond, and Houston Wood, "Preventing Iran from Getting Nuclear Weapons, Constraining its Future Nuclear Options," The Institute for Science and International Security, March 5, 2012, <http://isis-online.org/>

Weapons of Mass Destruction (WMD) Free Zone

The danger is that real arms control can be deflected by the search for an impossible red herring. Iran has countered US and outside efforts to force Iran to comply with the NNPT and IAEA inspection by denying and concealing its own activity while calling for a Weapons of Mass Destruction (WMD) Free Zone in the Middle East, which refocuses attention on Israel.

Iran has exploited the fact that Arab states have long called for a WMD free zone in a form that has focused on the fact Israel is the only active nuclear weapons power in the Middle East – largely ignoring their own chemical and biological weapons efforts. This gives Iran an opening, and forces the US to deal indirectly with Israel's current nuclear monopoly.

In 2010, The US, Iran and Arab nations agreed to call for UN talks in 2012 on a treaty to ban nuclear weapons from the Middle East.²⁶⁴ Under the treaty sponsored by the IAEA, permanent inspectors and surveillance technologies could be installed in the current or future civilian nuclear development programs of all twenty-two of the Arab League nations, plus Israel and Iran, backed by the threat of immediate sanctions and possible military action for any breaches of the agreement not to build weapons.²⁶⁵

All Middle Eastern nations, including Israel, have agreed to participate in the 2012 Conference, but this does not mean they support a functional agreement that would require all states to establish verification regimes for all forms of WMD – chemical, biological, radiological, and nuclear – and probably for key possible delivery systems as well. Moreover, Israel repudiated the language of the 2010 NPT consensus agreement, which noted that Israel's entrance into the NPT would be part of the process of creating a WMD-free zone, forcing Israel to decommission its undisclosed nuclear arsenal as a result:

This resolution is deeply flawed and hypocritical. It ignores the realities of the Middle East and the real threats facing the region and the entire world. It singles out Israel, the Middle East's only true democracy and the only country threatened with annihilation. Yet the terrorist regime in Iran, which is racing to develop nuclear weapons and which openly threatens to wipe Israel off the map, is not even mentioned in the resolution...as a non-signatory state of the NPT, Israel is not obligated by the decisions of this [NPT] Conference, which has no authority over Israel.²⁶⁶

Iran is almost certain to use the WMD free zone proposal to save face and maintain its ostensibly civilian nuclear program and, in exchange for the decommissioning of Israel's weapons, reassure the rest of the world that Iran isn't going to get the bomb either. It would also fit into their rhetoric of claiming the West holds a "double standard" that allows Israel to go unpunished for its reputed nuclear weapons arsenal.²⁶⁷

It would be desirable to have a WMD free zone agreement if it could be made real, tied to an Arab-Israeli peace, and an end to the growing arms race in the Gulf. The current climate of tension and military competition in the region preclude such an agreement, however, and this is certain to continue as long as Iraq moves forward towards nuclear weapons, Arab states attempt

²⁶⁴ BBC News, "UN talks back conference on nuclear-free Middle East", May 29, 2010.

<http://www.bbc.co.uk/news/10185256>

²⁶⁵ Time, "Is a nuclear-free Middle East a pipe dream?", Andrew Butters, September 23, 2009.

<http://www.time.com/time/world/article/0,8599,1925255,00.html>

²⁶⁶ The Prague Project, "A WMD-Free Middle East", Reid Pauly, February 24, 2011.

<http://www.pragueproject.org/2011/02/24/a-wmd-free-middle-east/>

²⁶⁷ Kenneth Katzman, "Iran: U.S. Concerns and Policy Responses," CRS, 9 June 2011, p.34.

to use the agreement to limit Israel without placing enforceable limits on all forms of WMD, and tensions drive an ongoing arms race.

As a result, proposals for a WMD free zone pose something of a dilemma to the US. Moreover, the risk in anything but a fully verifiable and enforceable agreement it might help keep a nation like Iran from openly acquiring nuclear weapons but not eliminate an ongoing effort to acquire all of the technology and equipment necessary to rapidly acquire the bomb in the future. The US must also risk choosing between rejecting the Arab position, or confronting Israel if it sides with Arab states -- many of which do not recognize Israel. So the US has been playing a delaying game on the issue.

Moreover, there is a wide range of other issues that make any effort to fully and effectively draft an agreement all side can trust extremely difficult

- Iran's emphasis on its nuclear and missile programs, and the fact that its enrichment and other activities have already brought it the nuclear threshold level – progress it can now disperse and conceal and which vastly increases the problems in verification and inspection of both its activities and ability to “break out” race to gain a nuclear weapons advantage engage in a post WMD Free Zone arms control environment.
- The uncertainties surrounding the ability to verify an Iranian agreement to give up all aspects of its nuclear weapons-related research and development and ensure that there is no covert program. These concerns are heightened by the fact that Iran announced in February 2010 that it would construct ten new enrichment facilities. The head of Iran's nuclear program did announced in August 2010 that this plan had been cancelled, but IAEA reporting since that time notes Iran has not provided data to confirm this and cites its "lack of cooperation."
- Israel's perception of the need to maintain and improve the size and capability of its nuclear and missile forces, its monopoly or a decisive lead in such forces, and the near impossibility of being certain that Israel had actually given up every weapon: The “Nth weapon” problem.
- The lack of any real prospects for a full Arab-Israeli peace, and the uncertainties created by the political upheaval in the Arab world.
- Syria's history of covert nuclear programs.
- Pakistan's growing nuclear weapons production and potential export capability – raising the threat of an outside supplier or forcing expansion of the arms control region to include Pakistan and India – which would then have to accept a Chinese monopoly.
- Uncertainties regarding other weapons of mass destruction in Israel and Arab forces, and regarding the size and nature of their missile, chemical and biological weapons programs,
- The prospect that biotechnology will advance enough in the region so that both Israel and major Arab states could develop effective genetically engineered or modified biological and
- The steadily growing difficulty in creating convincing verification and inspection regimes that affect all of these interacting variables.

Some key participants in the process say that US preparations for 2012 are under way at a time the US is pushing for delay until 2013 or beyond.²⁶⁸ It is possible that the US is hoping sanctions will force Iran to end its program and give into the West's demand before any WMD-free zone comes into existence, allowing Israel to keep its supposed arsenal and giving the US a major diplomatic win.

²⁶⁸ Global Security Newswire, “Mideast WMD-free zone inches forward amid gripes about US role”, Elaine Grossman, July 22, 2011. http://gsn.nti.org/gsn/nw_20110722_9247.php

At the same time, some Arab nations like Saudi Arabia have begun to consider creating their own nuclear programs to counterbalance a nuclear-armed Iran. A number of other Arab countries have expressed a growing interest in acquiring nuclear technology. According to the New York Times, Saudi Arabia is “scrambling to hire atomic contractors, buy nuclear hardware and build support for a regional system of reactors [...]Egypt has announced plans to build one on its Mediterranean coast [...]and] roughly a dozen states in the region have recently turned to the IAEA [...] for help in starting their own nuclear programs.”²⁶⁹ According to King Abdullah II of Jordan, “The rules have changed.”²⁷⁰

Regime Change and Regime Modification

The US does compete with Iran by seeking regime change or modification in Iran, although the scale and nature of this US effort is often grossly exaggerated and the US has concentrated far more on regime modification than regime change. The US has focused on sanctions and diplomacy as means of altering the current regimes behavior rather than on changing the regime -- although some experts seen the prolonged application of sanctions as a possible way to change Iran’s regime, given the existing pressures on the Iranian people coming from election fraud, crackdowns on social behavior, corruption, repression and restrictions on normal social behavior, internal power struggles at the top of the regime, and economic problems.

There is no way to accurately list and assess part and current US efforts at regime change and separate fact from fiction. In general, the current US Administration seems to feel that changes in Iran’s regime must come largely from within and as a result of action by the Iranian people. Many expert also feel that any direct or visible form of US support for regime change or for the opposition within Iran would be counterproductive.

Iranians are keenly aware of the West’s past interventions in Iran. Every Iranian knows all too well that the US and Britain have actively intervened in Iranian affairs in the past. US and British involvement in Iranian politics stretches back to the World War II occupation of Iran and the CIA and British-backed overthrow of democratically elected Prime Minister Mosaddegh in 1953.

Iran’s current leaders aggressively use Iran’s history and Iranian nationalist fears of outside intervention to try to win domestic support. Moreover, much of Iran’s current foreign policy is influenced by the desire to limit what Iranian clerics and officials view as corrosive foreign influence.

Rhetoric versus Reality

It is clear that the US has pursued a variety of different approaches to regime change or modification over the last decade. The George W. Bush Administration took a strong stand in favor of regime change – although this stand was more rhetoric than substance. In his 2006 State

²⁶⁹The New York Times, “Fearing Iran, Arab states seek nuclear power”, William Broad, April 15, 2007. <http://www.nytimes.com/2007/04/15/world/africa/15ihtnuke.1.5293038.html?scp=1&sq=Fearing%20Iran,%20Arab%20states%20seek%20nuclear%20power&st=cse>

²⁷⁰ The New York Times, “Fearing Iran, Arab states seek nuclear power”, William Broad, April 15, 2007. <http://www.nytimes.com/2007/04/15/world/africa/15ihtnuke.1.5293038.html?scp=1&sq=Fearing%20Iran,%20Arab%20states%20seek%20nuclear%20power&st=cse>

of the Union address, President Bush expressed his belief that “our nation hopes one day to be the closest of friends with a free and democratic Iran.”²⁷¹

Some accounts suggest that President Bush went as far as to authorize covert operations to destabilize the regime, involving assistance to some of the ethnic-based armed groups in Iran.²⁷² These reports, however, reflect Iranian claims that the US backed unrest among Iranian Baluchis in the East, and covert support of violent opposition movements as a result of the Iran Freedom Support Act which the US the Congress enacted in 2006. This legislation authorized funding for the active promotion of democracy in Iran, and was debated in ways that gave the impression that the US might use the funds to directly seek the overthrow of the Iranian regime.²⁷³

There is no meaningful evidence, however, that the US actively backed Baluchi or any other violent form of Iranian opposition, or actively intervened internally in Iranian politics. The Bush Administration clearly realized the damage that any such US action could do to Iranian dissidents and moderates if—as was inevitable—it became public.

President Obama initially took a more moderate public approach regarding regime change. The first major public manifestation of this vision for came in March 2009 during a message to the Iranian people on the occasion of Nowruz. He stated that the United States “is now committed to diplomacy that addresses the full range of issues before us, and to pursuing constructive ties among the United States, Iran, and the international community.”²⁷⁴

He also referred to the country as “The Islamic Republic of Iran,” a formulation that appeared to some to suggest that the US had accepted the regime and Islamic revolution, and was no longer seeking regime change.²⁷⁵ In concert with that approach, Obama Administration officials initially withheld overt support for hardline approaches, such as military action, although no options were explicitly “taken off the table.”²⁷⁶

The tone in Washington changed when Iran failed to respond in any way that offered the US confidence the regime would become more moderate, and as nuclear talks stalled and Iran harshly put down protests in Tehran following its 2009 election. The US was cautious in reacting; again because of the fear that the Iranian regime would use US criticism to discredit moderates and demands for greater freedom and legitimacy.

It became apparent, however, that US restraint would not help. In December of 2009, President Obama addressed the protests in Iran and declared: “Along with all free nations, the United States stands with those who seek their universal rights.”²⁷⁷ Obama’s 2011 Nowruz statement

²⁷¹ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” Congressional Research Service, June 9, 2011, p. 59.

²⁷² ABC News, “Bush Authorizes New Covert Action Against Iran,” Brian Ross & Richard Esposito, May 22, 2007. http://blogs.abcnews.com/theblotter/2007/05/bush_authorizes.html.

²⁷³ HR 6198, “Iran Freedom Support Act,” The Library of Congress, September 30, 2006. <http://www.gpo.gov/fdsys/pkg/BILLS-109hr6198rds/pdf/BILLS-109hr6198rds.pdf>

²⁷⁴ The Washington Post, “Obama’s Message to Iran,” Thomas Erdbrink, March 21, 2009. <http://www.washingtonpost.com/wp-dyn/content/article/2009/03/20/AR2009032000398.html>

²⁷⁵ Ibid

²⁷⁶ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” Congressional Research Service, June 9, 2011, p. 53-54.

²⁷⁷ White House, Office of the Press Secretary. “Statement by the President on the Attempted Attack on Christmas Day and Recent Violence in Iran.” December 28, 2009.

reflected this changing diplomatic approach, expressing criticism of the government in Tehran and support for insurgent pro-democracy movements.

This address was widely noted for its open support of Iranian protesters, its condemnation of abuses against specific, named dissidents, and absence of any renewed overture to Iran's leaders.²⁷⁸ Obama Administration officials did, however, stop short of publically calling for regime change.²⁷⁹ Moreover, no credible reports have surfaced of any form of US covert action against the regime.

The Obama White House appears to have remained cautious -- in large part because it still feels new and visible US efforts would be used to discredit the Iranian opposition. The Congress again took a stronger position. In 2010, legislation was introduced in the Senate that called for the United States to: "fully and publicly support efforts made by the people of Iran to oppose and remove the regime [...] from power in Iran; and to promote the emergence of a freely elected, open, and democratic government to replace the political system of the Islamic Republic of Iran."²⁸⁰

The Impact of Iran's March 2012 Parliamentary Elections

It seems less likely that either popular unrest or the internal power struggles within Iran's regime will change this situation in the near future. In March 2012, Iran held its first national election since the disputed presidential elections in 2009 and the large Green Movement protests that followed. The run-up to the March 2012 elections was quite unusual in that the contest was not between reformist and conservative elements as in the past. Rather, this election quickly became an unusually public referendum on President Ahmadinejad and his challenge of the Supreme Leader.

The dispute between rival factions of the conservative camp was over power, but more importantly, the direction the Islamic Republic has headed three decades after Khomeini's revolution. While some saw this internal division as the first signs of the regime's eventual downfall, Khamenei's overwhelming victory consolidated his control, strengthening his command over the parliament, judiciary, and security forces.

As political tension between Ahmadinejad and Supreme became more overt in the lead up to the election, Supreme Leader Khamenei declared participation was religiously obligatory:

"On Friday's election day... the Iranian nation will give a slap harder than the previous ones in the face of [Global] Arrogance and will show its decisiveness to the enemy so that the front of Arrogance understands that it can't do anything when confronting this nation... All over the world, an enthusiastic election is the symbol of the nation being alive and [a symbol of] their will. Therefore, in any country in which there is vast popular participation in the election, it is a sign of their vigilance and their harmony with the regime..."
–Supreme Leader Khamenei²⁸¹

²⁷⁸ The White House Blog, "President Obama's Nowruz Message," Nikki Sutton, March 20, 2011.

<http://www.whitehouse.gov/blog/2011/03/20/president-ob-ama-s-nowruz-message>

²⁷⁹ Kenneth Katzman, "Iran: U.S. Concerns and Policy Responses," Congressional Research Service, June 9, 2011, p. 59.

²⁸⁰ Iran Democratic Transition Act of 2010, S3008, Library of Congress. <http://thomas.loc.gov/cgi-bin/thomas>
http://www.opencongress.org/bill/111-s3008/news_blogs

²⁸¹ "Iran News Round Up, February 29, 2012", AEI Iran Tracker, February 29, 2012.

On March 1, 2012, conservatives easily won the vast majority of the parliamentary seats, winning 143 of 290 possible seats. Reformists, who largely boycotted the elections, won only 59 seats. More importantly, however, is the fact that pro-Khamenei candidates made considerable gains over those loyal to Ahmadinejad. Having contested the Supreme Leader's power, Ahmadinejad can expect to find himself significantly weakened and marginalized in the aftermath of these elections.

Indeed, the following statements by Pro-Khatami loyalists since the March 1, 2012 elections suggest this trend had already begun:

- "We were under circumstances in which the elected president acted against Islam, Imam Khomeini, and the interests of the state. He was even guilty in shedding the blood of hundreds of innocent martyrs...One can't say there was electoral fraud and that he came to power by fraud. There was no fraud. However, there was lack of knowledge. After that some events took place and we understood that we were mistaken [in our support to Ahmadinejad]." -Ayatollah Mohammad-Taqi Mesbah Yazdi²⁸²
- "Ahmadinejad was not without guilt in the post-election events." -Abd al-Hossein Rouh-al-Amini, Development and Justice party Secretary General²⁸³
- "Opposing the Resistance Front is opposition to original Islam." -Hojjat al-Eslam Mojtaba Mesbah Yazdi, advocating for one anti-Ahmadinejad party²⁸⁴

The question now is how domestic Iranian politics plays out in the coming months as the regime comes under increased scrutiny for its nuclear program, sanctions continue to take their toll on Iran's economy, and the conservatives dominate Iran's new parliament. Supreme Leader Khamenei did consolidate his control of power by delivering a humiliating blow to his political rivals, but the question at what cost. By playing his hand so overtly, Khamenei may have lost the ability to command all of Iran's power without of the accountability. Since Khamenei assumed the office of Supreme Leader following Khomeini's death in 1989, Khamenei has enjoyed wielding omnipotent power without assuming any accountability, allowing his weaker and largely symbolic Presidents to take responsibility and blame for the country's problems. This was the case during the presidential tenures of Rafsanjani, Khatami, and Ahmadinejad's first term. However, his domination of the March 2012 parliamentary elections runs the risk of exposing—and undoing--this carefully cultivated buffer between the Supreme Ruler and the ordinary citizen. We must wait to see if the Iranian people allow Khamenei to exercise unchecked control over the spoils of power into the future, or they call him to account for the mounting hardships they face.

US Initiatives and Information Campaigns Over the Last Decade

There is no question that the US would like to see a different, and far more moderate and democratic regime in Iran, However, US has relied largely on information campaigns and the support of Iranian exiles to influence Iranian public opinion since the fall of the Shah, and faces the reality that any overt support of Iran's internal opposition could lead to serious backlash and lead many Iranians to support the existing regime/ The same is true of most options for covert

²⁸² "Iran News Round Up, March 1, 2012", AEI Iran Tracker, March 1, 2012.

²⁸³ "Iran News Round Up, March 1, 2012", AEI Iran Tracker, March 1, 2012.

²⁸⁴ "Iran News Round Up, March 1, 2012", AEI Iran Tracker, March 1, 2012.

action. The US has limited practical leverage over internal events in Iran, and any direct support of Iranian dissidents would inevitably leak, discredit them, doing them more harm than good.

The US has launched a series of initiatives over the last decade to promote opposition parties in Iran. Radio Farda (“tomorrow,” in Farsi) began in October 1998 as a project of Radio Free Europe/Radio Liberty, in partnership with the Voice of America (VOA). The VOA also established a Persian language service to Iran (VOA Persian Service) in July 2003.²⁸⁵ In July 2007, it was renamed Persian News Network (PNN), encompassing radio (1 hour a day or original programming); television (7 hours a day of original or acquired programming, rebroadcast throughout a 24 hour period); and Internet.²⁸⁶

Since 2010, the Obama Administration has broadened the scope of its democracy promotion programs. In addition to the traditional efforts to fund journalists, human rights activists, visit programs, the Administrations has sought to work directly with individuals inside Iran who are organized around apolitical issues such as health care, the environment, and science.²⁸⁷ Washington has begun to “tweet” in Farsi as well as Arabic, and the Obama administration has made efforts to help the Iranian opposition circumvent government attempts to monitor or cut off communications.²⁸⁸

According to the *New York Times*, the Administration has initiated a global effort to deploy “shadow” Internet and mobile phone systems that dissidents can use to undermine repressive governments that seek to silence them by censoring or shutting down telecommunications networks.²⁸⁹ Similarly, the State Department is financing the creation of stealth wireless networks that would enable activists to communicate outside the reach of governments; an effort with clears implications for any Iranian opposition party.²⁹⁰

In December 2011, the US launched a “virtual embassy” in Iran, a website which was quickly blocked by Tehran amidst allegations that the US was attempting to recruit spies and foster internal regime change. US State department officials claimed that the site was merely an attempt to communicate to Iranians about their ability to secure student visas and explain US policy. It appears clear, though, that the effort was aimed at weakening support for the regime among young, technically-savvy Iranians. This is only the latest US attempt to make pro-American media and resources available to populations inside Iran.

It is unclear that such US efforts are making progress in changing the nature or behavior of the Iranian regime; although they almost certainly help keep Iranian moderates and opponents of the regime informed and give them some outside support. There is still hope in Washington that the kind of protests that followed the last presidential election in Iran will lead to popular political upheavals. The evidence to date, however, indicates that the government in Tehran has successfully consolidated power after widespread uprisings in 2009 and a brief spat of protests in early 2011.

²⁸⁵ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” Congressional Research Service, June 9, 2011, p. 62.

²⁸⁶ Ibid

²⁸⁷ Wall Street Journal, “U.S. Shifts Its Strategy Toward Iran’s Dissidents,” June 11, 2010.

²⁸⁸ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” Congressional Research Service, June 9, 2011, p. 59.

²⁸⁹ The New York Times, “U.S. underwrites internet detour around censors,” James Glanz and John Markoff, June 12, 2011. <http://www.nytimes.com/2011/06/12/world/12internet.html?pagewanted=all>

²⁹⁰ Ibid

The March 2012 Iranian “election” for Iran’s 290 seat parliament did not produce wide protests, in spite of the fact it was rigged to prevent any serious opposition candidates from running, and there were at least some abuses in counting the vote. The Supreme Leader also seems to have been able to push aside President Mahmoud Ahmadinejad’s faction with comparative ease, and consolidate the power of one main conservative faction.

There are few signs of any active challenges or divisions within the military, IRGC, Basij, or intelligence services. There have only been token signs of organized opposition since the two-year crackdown following the last Presidential election, the opposition consists largely of the clerics that have lost power, and polling data showed consistent popular support for Iran’s nuclear programs through late 2011.

Yet, many political upheavals begin after years of repression and without warning. Expanded sanctions will impact the Iranian economy and the life of most Iranians, and significant minorities within Iran appear disaffected by the government in Tehran.²⁹¹ This may modify the regime at least on nuclear issues, and US should continue to position itself on the side of democracy and human rights. There is little evidence to date that the US should expect regime change, or that any covert program is likely to make substantial progress versus convincing many Iranians of America’s hostile intent once it is exposed. Regime change from within, however, is at least possible.

The “Indirect Approach”

The best approach for the US may well be to let Iranians take the lead in whether to modify or change the regime. This does not mean abandoning strategic communications efforts that allow Iranians outside Iran to talk to Iranians inside Iran, information campaigns that prevent the Iranian government from distorting or concealing the realities surrounding issues ranging from economics to human rights, or strongly backing the efforts of the UN and outside human rights organizations.

It does mean avoiding political posturing and hollow calls for covert action, actual covert action that will inevitably be discovered and discredit the internal opposition in Iran, backing extremist cults like the MEK, and repeating the mistakes the US made in Iraq and Afghanistan in backing exiles that lack credibility and often do as much harm as good. The US also needs to consider whether it would do better in working with European and NGOs in strategic communications and decoupling the US as much as possible from the message – minimizing links between the US and its historical baggage – and calls for reform.

The US should, however, do far more to modify or change the regime in a different way. The US message to the Iranian people -- and to any elements in the regime that want change and are willing to give up the dangerous elements of Iran’s nuclear programs and behavior – should not focus so heavily on sanctions and the threat of war.

The US should make it clear both independently and in working with the 5+1 that there are strong incentives for Iran to give up its nuclear weapons related efforts and to establish better relations with the US. These include a rapid end to sanctions, but also trade and investment incentives, easing of visa restrictions, and other measures that show the Iranian people and the regime that the US has clearly defined positive programs and goals that will benefit Iran. This

²⁹¹ Kenneth Katzman, “Iran: U.S. Concerns and Policy Responses,” Congressional Research Service, June 9, 2011,

does not mean abandoning either sanction or the search for security, but it does mean trusting in the fact that the best way to both modify and change the regime is to create a climate where it cannot demonize the US and isolate Iran, and where it is clear that changes in the regime and its behavior can take place over time.

Implications for US Policy

While the full effects of new sanctions will not become apparent until late 2012 at the earliest, they already are cutting Iranian energy exports and revenues, creating serious banking and trade problems. Iran has made its frankest admissions to date that sanctions are having a major impact. The Iranian rial has become destabilized, and it fell to record lows in January as currency markets reacted to the prospect of more limited foreign trade. The Iranian government, the Iranian economy, and the Iranian people are already feeling the pressure.

The Iranian reaction has been mixed:

- On the one hand Iran's Foreign Minister did call for renewed nuclear talks with the West in January 2012 -- although, past history warns that Iran's negotiating efforts may be little more than another round of delay tactics. This new call for diplomatic engagement seems likely to be a ploy to buy time, and is a familiar part of the US-Iranian Strategic relationship
- On the other hand, Iran has issued far serious threats to "close the Gulf" than in the past and Iran carried out missile tests and military maneuvers. Iran's threats and exercises have also been followed by the announcement that it is creating a new, far better sheltered underground uranium enrichment facility and deploying much more efficient centrifuges.

As Chapters III and IV have discussed, the US must be ready for contingencies that could trigger a significant clash or conflict in the Gulf, Israeli preventive strikes, and even serious US military action that escalate to the point where the US might have to strike at Iran's overall base of asymmetric forces, conventional forces, or nuclear and missile forces. While the US should pursue sanctions and diplomatic options, it must also begin to make hard longer-term choices regarding the possibility that sanctions and diplomacy fail.

This means choosing between containment and preventive strikes, and doing so on the basis of the kind of classified analysis of future options that require full access to both intelligence and military planning data. The choice between bad options should always be as objective as possible, and based on the best information and modeling, and many of the key variables are now so highly classified that outside analysis is severely limited.

The Key Near-Term Choices for US Policy

In the near-term, the US needs to do everything it can to ensure that sanctions lead to successful negotiations. This means pursuing the following options:

- *The US should do everything possible to create UN, multilateral, and national sanctions that are as effective as possible.* The time for gradual approaches is over. If there is to be a peaceful outcome to this aspect of US and Iranian competition, it must come before Iran tests a nuclear device or deploys a nuclear weapon. It must come before Israel takes preventive action or the region becomes locked into a nuclear arms race, and Iran creates a technology base so advanced that current IAEA inspection methods cannot guarantee that it is not developing more advanced capabilities to produce fissile material and the other components of a nuclear weapon covertly or under the guides of carefully compartmented research and develop in area like advance centrifuges and weapons design.
- *Make it clear that the US and its allies also offer Iran incentives to halt, and explain sanctions continuously.* Show other countries that the US and the 5+1 offer Iran real incentives to halt nuclear

weapons related activities, and explain and justify sanctions in terms that nations in other regions can fully understand. Sanctions are not enough. Iran needs to see that the US and the rest of the 5+1 will offer incentives in terms of enrichment, fuel supplies, a rapid lifting of sanctions, trade, investment, and energy development. If sanctions are the “stick,” the US must act to ensure that there are real and immediate carrots.

- *The US must work closely with its European, Gulf, and Israeli allies.* The US cannot assume its allies will follow or trust it if does not communicate, consult, and treat them as partners. This is an area where it must be transparent enough to convince the world it is not repeating the mistakes it made in going to war in Iraq, that it will not act precipitously, and it will listen as much as it attempts to lead.
- *Make a convincing case to the Iranian people, its allies and the world that Iran is seeking to obtain nuclear weapons and could be a threat to the global economy.* It is not enough to cite the IAEA and keep up diplomatic pressure. Continue to work with the IAEA and key allies like Britain, France, and Germany to show the dangers in Iran’s actions and make the threat it poses fully convincing. Explain how a crisis in the Gulf could threaten all countries – including the developing countries outside the region. Make the case through effective strategic communications and as objectively as possible.
- *Use arms transfer efforts to supplement sanctions.* The US must do everything possible to keep China, Russia, and other nations from transferring advanced arms and military technology to Iran, or any technology and equipment that could aid it in developing nuclear weapons. At the same time, as is outlined in Chapter VI, it must work with its Arab Gulf allies and Turkey to give them as strong a mix of defenses and deterrents as possible, help Israel achieve the kind of security that can reduce the incentive for preventive strikes, and – as is discussed in Chapter VII – do what it can to make Iraq secure and a real security partner.
- *Work with the UN, IAEA, and its allies to update the arms control proposals necessary to ensure that Iran is complying with a meaningful and verifiable agreement.* It will not be enough for Iran to deal with the immediate concerns raised by the IAEA. It must be clear that any negotiation ends in a viable agreement.
- *Avoid aggressive interference in the form of regime change, but support strategic communications by Iranian exiles and encourage internal Iranian movement towards moderation and democracy.* Focus on regime modification in dealing with the nuclear issue and threat in the Gulf, and leave regime change to Iranians.

Arms Control Offers Hope But a WMD Free Zone Offers Little Probability of Success

The US must support arms control in enforcing the NNPT and giving the IAEA the necessary tools and freedom of action as critical policy option. However, a weapons of mass destruction free zone has virtually no chance of being negotiated in a meaningful form for five reasons:

- Iran’s emphasis on its nuclear and missile programs,
- Israel’s need to maintain nuclear and missile forces,
- The lack of any real prospects for a full Arab-Israeli peace,
- Arab missile, chemical and biological weapons programs and growing interests in nuclear programs, and
- The steadily growing difficulty in creating convincing verification and inspection regimes.

The Uncertain Result: Giving Diplomacy Priority While Preserving Security

Sanctions and diplomacy are the best of a bad (or at least highly uncertain) set of options, but it is far from clear that they will stop Iran from moving toward a nuclear weapons capability, or the actual deployment of nuclear forces. The end result could still be successful negotiations with

Iran, but it could also be the beginning of years of more intensive confrontation with Iran at every level.

The risks become higher as time goes on, and this aspect of US and Iranian competition turns into a “long game.” So far, Iran has backed away from military confrontation, but it is far less clear what will happen if sanctions result in a prolonged confrontation. Iran has at least as much to lose as any other Gulf state if it halts oil exports and imports through the Gulf. Iran also cannot hope to win any serious conflict with the US and its Gulf allies..

Iran’s increasingly belligerent statements and actions have already affected the price and flow of oil. Oil prices rose around the world on February 20, 2012 when Iranian officials responded to new European sanctions by halting exports to Britain and France. Two days later, the head of the Iran’s armed forces, Mohammad Hejazi hinted preemptive action on Iran’s part, stating, “Our strategy now is that if we feel our enemies want to endanger Iran's national interests...we will act without waiting for their actions.” In addition to Iran’s regular threats to close the Strait of Hormuz, this most recent behavior has limited impact on global energy prices.

A period of confrontation and sanctions that lasted for several years will mean lasting increase in oil prices and pressure on the world economy. It will also allow Iran time steadily improve its options and tactics for asymmetric attacks and political warfare, and evidence that Iran actually had a nuclear weapon might both lead many nations to abandon sanctions and make the credibility of US, European, and Southern Gulf escalation major conflicts and strikes on Iran less credible.

Iran will have to take risks of its own, and has no inherent advantages in playing the “long game.” Hostile Iranian actions and Iran’s steady movement towards nuclear weapons capability would probably strengthen US, European, and Southern Gulf resolve, and support for sanctions. Iran would pay a steadily higher cumulative cost as a result of the impact of sanctions over time, and popular support for the regime might well erode. Iran cannot be certain it can use low level asymmetric tactics without provoking the US and other states to escalate to much higher levels of conflict, or be certain it can control the course of events and the risk of some incident leading to serious attacks on Iran’s military forces and other assets.

History, however, is scarcely a consistent record of successful deterrence, rational calculations, and intelligent compromises. Rising pressure on Iran can lead it to take risks, and exercise the kind of military options describe in Chapters III and IV. Limited or demonstrative military actions can become serious clashes, and accidents can escalate into war. At the same time, Iran’s progress towards a nuclear weapons capability can lead Israel to carry out preventive strikes, and force the US to choose between “containment” based on a military build up and extended deterrence or the large-scale preventive strikes necessary to ensure Iran does not deploy nuclear weapons.

The end result is that the US, its Southern Gulf allies, Jordan and other friendly Arab states, and Israel may well face years in which the struggle over sanctions, energy exports, and arms control outlined in this analysis remain part of a process of steadily escalating confrontation at many other levels. What many today are describing as a “crisis” may well be an enduring reality that can only be ended by internal regime change in Iran and only be contained by close cooperation between the US, Arab states in the Gulf and elsewhere, along with key allies like Britain and France.

Negotiations that focus on Iran's nuclear programs will have important limits even if they succeed. Iran is building up its long-range conventionally armed missile forces, it remains a declared chemical weapons power, and it has biological as well as nuclear options. As its recent exercises in the Gulf show, Iran is also steadily building up its capabilities for asymmetric warfare in ways that can threaten and be used to deliver a wide range of attacks. It continues to use its Al Quds force, intelligence services, and diplomats to pose a growing threat to the Arab states and Israel, in addition to seeking an axis of influence that includes Iraq, Syria, and Lebanon.

This means that a continued focus on sanctions and arms control efforts must be supported by the continued development of military capabilities to deter and contain Iran. The US should preserve and enhance its ability to use force against Iran. The US and its allies should make it clear to Iran that if it conducts nuclear tests, is found to be assembling nuclear weapons or begins to deploy a nuclear-armed missile force might justify the preventive use of military force.

The US and its allies should also find ways to warn Iran that any major Iranian effort to "close the Gulf," or large-scale conventional or asymmetric clash between Iran and either the US or the GCC, could lead to escalating uses of force. Efforts to remove Iran's nuclear, missile, and key military facilities would then occur in a radically different context and have far more international support.

At the same time, the need to deter and contain Iran while sanctions and negotiations are still an option is very different from giving military options a priority. The real world political and strategic results of replacing sanctions and diplomacy with the use of force are so unpredictable, and the risks are so high, that force must be a last resort relative to both diplomacy and containment. Such risks should only be viewed differently if it becomes clear that show Iran's regime has reached ideological extremes where it cannot be deterred by missile defenses, the forces in the Gulf, and threats like a US commitment to extended deterrence.