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US's Iran Sanctions:
Mixed Prospects and a Beyond-SWIFT Question

James M. Dorsey

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Al Jazeera Centre for Studies
Tel: +974-40158384
jcforstudies@aljazeera.net
http://studies.aljazeera.n

[Getty]

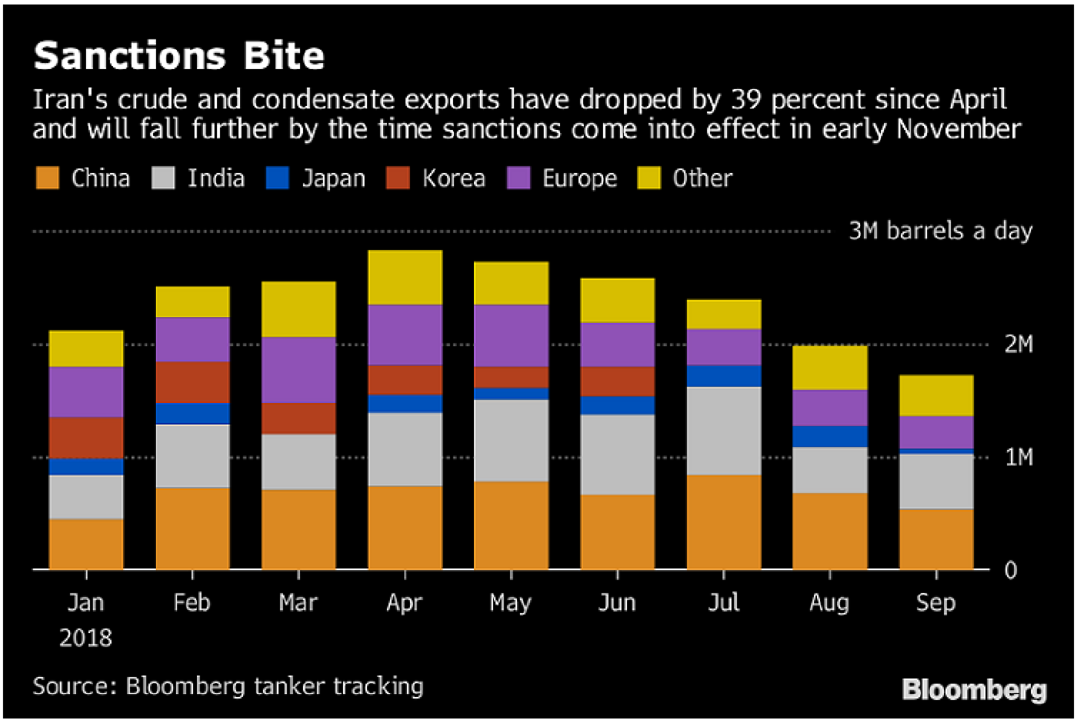
US President Donald J. Trump's campaign to cripple Iran economically by imposing harsh economic sanctions and force either changes in Iran's regional policies or even better, regime change, have gotten off to a relatively slow start. With much of the international community pledging to salvage the 2015 international agreement that curbed Iran's nuclear agreement after Trump withdrew from the deal in May, the United States is discovering that enforcing the sanctions that aim to reduce Iranian oil exports to zero, cripple its shipping industry, and cut the Islamic republic out of the international financial system is easier said than done. While Iran will likely feel significant pain, Europe, China, and Russia have pledged to soften the blow to the degree possible by continuing to purchase Iranian oil, invest in the Islamic republic and create mechanisms to do business in currencies other than the US dollar.

The jury is out on whether that persuades Iran that the advantages of sticking to the nuclear agreement outweigh the disadvantages. That in turn could depend largely on Europe's ability to ensure that Iran is not excluded from the Brussels-based Society for the Worldwide Interbank Financial Telecommunication (SWIFT) international financial messaging system used by more than 10,000 banks worldwide(1) for their more than 30 million transactions a day or is able to create one or more special purpose vehicles to which China, India, South Korea, Japan, and Turkey, who accounted for 70 percent of Iran's oil exports would have access in 2017.(2)

A Stuttering Start

President Trump's severe economic sanctions appeared to be manoeuvring an obstacle course even before they kicked in on November 5 despite US estimates that the measures had already led to a reduction of Iranian oil exports from 2.7 million to 1.6 million barrels a day. The impression that the sanctions were getting off to a modest start was reinforced by the fact that the United States gave eight countries, including the major importers of Iranian oil -- China, India, South Korea, Japan, Italy, Greece, Taiwan and Turkey – 180-day waivers that, according to Secretary of State Mike Pompeo, had already reduced their purchases from the Islamic republic. China, India, South Korea, Japan, and Turkey accounted for 70 percent of Iranian oil exports in 2017.(3) Earlier the US Treasury issued a license that allows an Iranian-backed gas field in the North Sea that accounts for three percent of Britain's gas supply to keep operating.(4)

Pompeo said the waivers were designed to "ensure a well-supplied oil market." He mentioned two of the eight countries had pledged to reduce their imports to zero within the six-month period of the waiver, while the other six had agreed to "greatly reduced levels."(5) Trump defended the waivers, saying he was going slow on the imposition of the sanctions to prevent shocks in the oil market and a spike in prices. "I could get the Iran oil down to zero immediately, but it would cause a shock to the market. I don't want to lift oil prices," Trump told reporters.(6)



[Bloomberg]

The United States has also trumpeted the fact that the sanctions sparked the collapse of the Iranian currency, the rial, wreaking havoc on the average Iranian. Unemployment is shooting up, especially among the country's youth, inflation is spiralling higher because of the cost of imported goods, and there have been water and power shortages due to a lack infrastructure investment after years of on-again, off-again sanctions.(7) Raising fears that Iran would ration fuel and hike prices, the government in December reintroduced fuel cards to put a halt smuggling of up to 40 million litres a day.(8) Smuggling of other subsidized goods such as pharmaceuticals and foodstuffs as well as non-subsidized items like textiles has reportedly increased sevenfold in recent months.(9)

The Trump administration hopes the sanctions will complicate the Iranian support for groups like Lebanon's Hezbollah Shiite militia and the Houthis in Yemen, as well as its military operations in Syria by forcing the Islamic republic to reduce military spending. It bases its hope on the fact that in the decade prior to the lifting of sanctions as part of the 2015 nuclear agreement dropped by 30 percent, "one of the highest percentage decreases in military spending globally," according to Iranian researchers Sajjad F. Dizaji and Mohammad Farzanegan.(10)

The researchers argued that the difference in the sanction regime prior to the agreement and the current US measures is that the Trump administration's sanctions are unilateral rather than multilateral. "While unilateral sanctions are not shown to influence Iran's military burden significantly, the impact of multilateral sanctions is negative and statistically significant," Dizaji said. Military expenditures, moreover, accounts for only three percent of Iran's gross domestic product.(11) Even so, the International Crisis Group concluded that the period of multilateral sanctions and reduced military expenditure "coincided with what many consider the most significant expansion of Iran's military intervention in the region."(12)

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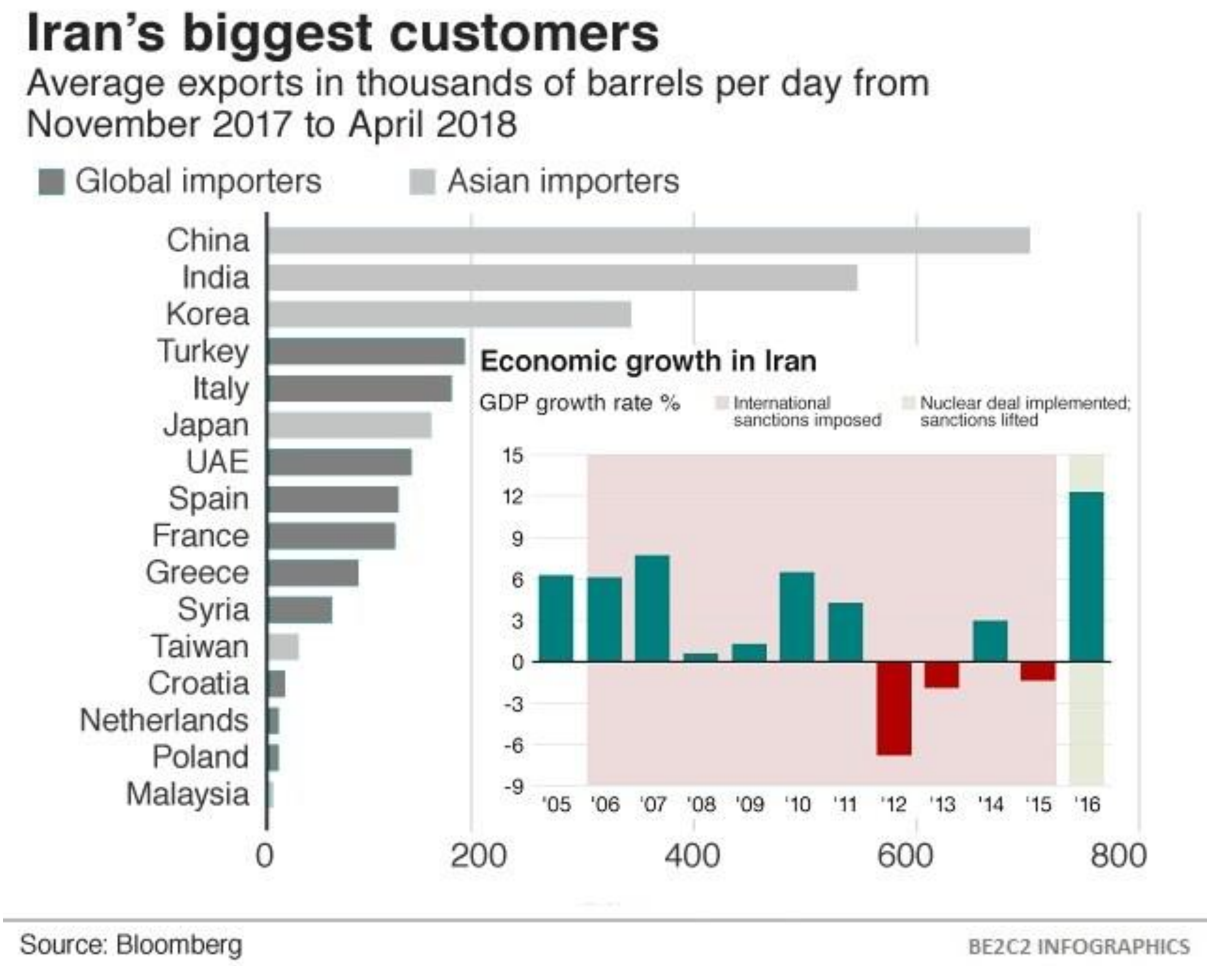
Reality Kicks In

The implication of Trump's and Pompeo's remarks on waivers was that increased production by suppliers such as Saudi Arabia and Russia, while compensating for the reduced Iranian oil sales, could spark a fight for market share, which could fuel price increases. They also suggested that the United States believed that there was currently not oil in the market to replace Iranian crude. The United States assumption that Iran, a country with a long experience in circumventing sanctions, may have an oil industry that remains robust despite its travails.

The waivers recognized that the countries involved had no immediate alternative sources for oil. Three of the eight waiver recipients — Greece, Italy and Turkey — are members of NATO. Japan and South Korea have mutual defense treaties with the United States and play key roles in the North Korea denuclearization initiative. India, the world's largest democracy, is crucial to the administration's Indo-Pacific strategy, which seeks to unite countries in the region to counter China's growing assertiveness. China is the largest importer of Iranian oil. Forcing it to seek alternatives would have spark shock tremors in the market.

US officials attribute their apparent success in already reducing Iranian exports to the strength of their alliances and the fact that countries and companies do not want to risk being barred from access to US markets.(13) Japan and South Korea stopped buying Iranian crude ahead of the sanctions. Japan nonetheless negotiated a waiver for 100,000 barrels per day, down from the 165,000 barrels it was buying prior to the threat of US measures while South Korea was granted a quota of 200,000 barrels a day.(14) The two countries said they were looking to renew imports in January.

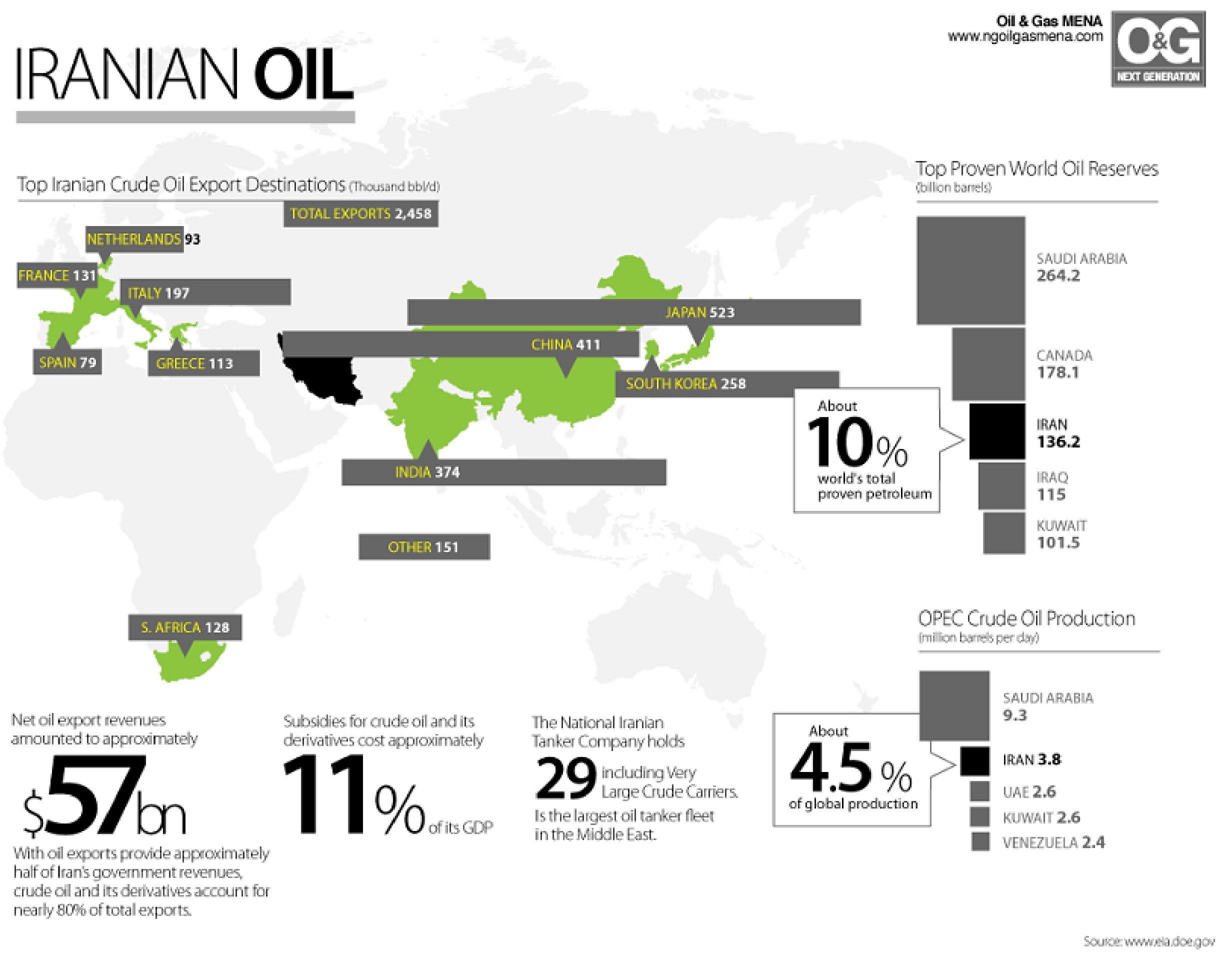
India is officially asserting that it is importing at the agreed rate of 360,000 barrels per day.(15) By the same token, Indian claims that it had significantly reduced prior to the waiver are countered, according to energy analyst Ellen R. Wald, quoting TankTracker com. The online monitor of oil tankers reported that Indian oil imports from Iran rad remained virtually unchanged in recent months. Iranian exports are frequently hidden by tankers that make stops at multiple Gulf ports and at times shut down their responders to camouflage their movements. "The data on oil movements show conclusively that Iran's oil exports have not decreased nearly as much as the media narrative has suggested… Oil speculators and the Trump administration have been led to believe that the threat of impending sanctions on Iran's oil is removing so much from the market that oil prices could skyrocket to $100 per barrel this year. The actual data on Iran's oil exports contradict this," Wald said.(16)



Moreover, relatively unnoticed was a non-oil related waiver granted to India that allows it to maintain its infrastructural investment in the Iranian port of Chabahar on the shore of the Arabian Sea, a mere 70 kilometres from the Chinese-backed Pakistani port of Gwadar.(17) The port would facilitate Indian links to Central Asia by bypassing arch rival Pakistan, contribute to economic development in Afghanistan and pre-empt Chinese efforts to gain a foothold in Chabahar. Similarly, there is no indication that the US will sanction Russian, Chinese, and European companies assisting Iran with its nuclear sites, Fordow, Arak, and Busher.(18)

China is one joker in the pack. It negotiated a waiver for 360,000 barrels per day but retains the right to production from fields in Iran in which Chinese companies have a stake. They include China National Petroleum Corp's (CNBC) 75 percent stake in Iran's MIS and the North Azadegan oilfield. China moreover has a history in busting sanctions against Iran. In the years prior to the nuclear agreement, China used the Bank of Kunlun, established in 2006 in its troubled, oil-producing north-western region of Xinjiang as its handler of Iranian oil payments in violation of UN and UN sanctions. The bank was sanctioned by the US Treasury for its business with Iran, including transferring funds to Iran's Revolutionary Guards Corps. Kunlun in October halted yuan and euro denominated payments from Iran in anticipation of the US sanctions.(19)

Turkey is another joker. Refusing to bend to the US sanctions would enhance its goal of exploiting its geography to become a gas and oil transit hub. To do so, Turkey will have to extend its current gas agreement with Iran that risks losing its Turkish market share to producers like Qatar, Russia Azerbaijan and the United States. The question is whether Iran can make a gas agreement sufficiently attractive in terms of pricing as well as facilitating Turkish objectives in Syria where it is determined to stymie Kurdish aspirations. Payments and pricing are but one, albeit the most immediate issue. Longer term, Iran will face significant difficulty if it can't secure the technologies to enhance production from its predominantly mature oilfields. Iran currently uses out-of-date technologies like pumping natural gas into the old oil fields to produce ever-dwindling amounts of oil. That is likely to become untenable with retail, commercial and industrial gas consumption on the rise. Countries like China and Russia are unlikely to meet standards of technologies developed in the United States and Europe." As long as Washington can prevent it from obtaining vital enhanced oil recovery technologies, Iran's economy will become increasingly fragile," said energy scholar Micha'el Tanchum.(20)



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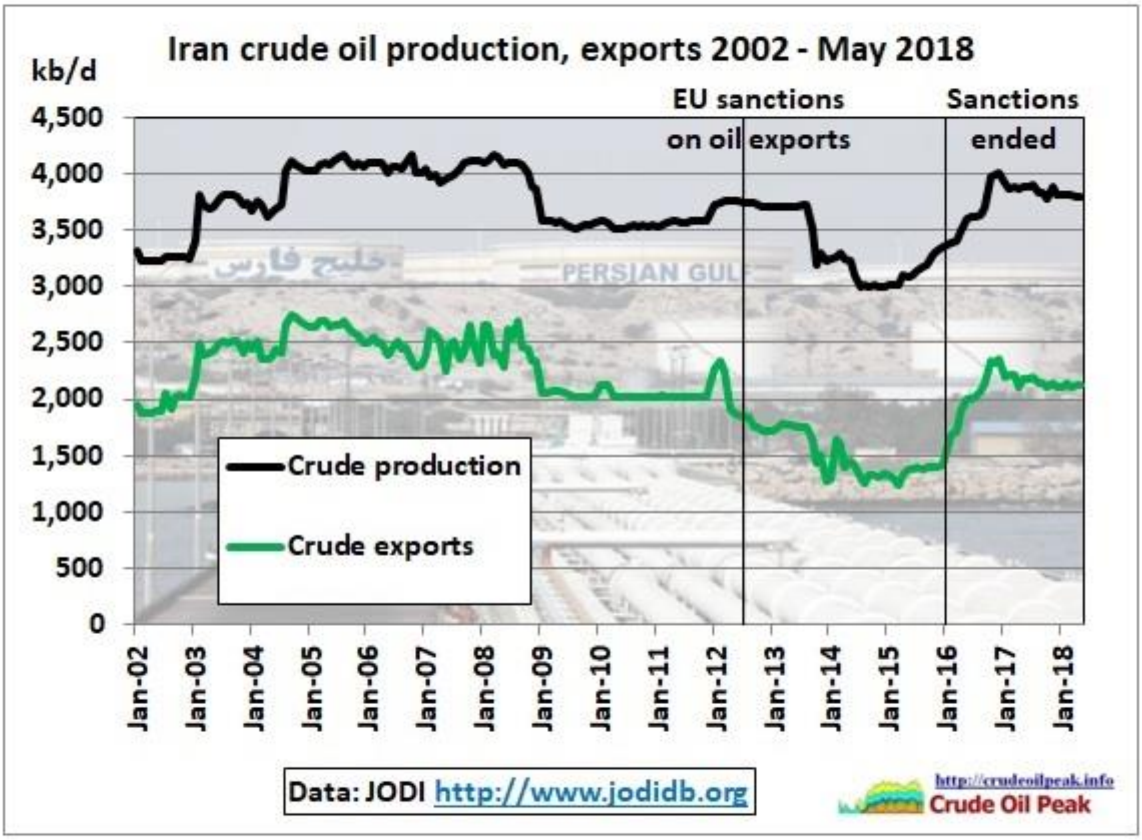
The November sanctions constituted round two. Earlier sanctions imposed in August targeted Iran's steel, aluminium and auto sectors by limiting access to raw materials and essential parts. They prompted together with the prospect of the November sanctions major European companies like Total, A.P. Moller-Maersk, Peugeot, Renault, Airbus, Alstom and Siemens to withdraw from Iran. "There is a primacy of the (US) political system. If that primacy is 'This is what you are going to do,' then that is exactly what we are going to do. We are a global company. We have interest and values and we have to balance both," said Joe Kaeser, the chief executive of German industrial conglomerate Siemens.(21) Put more forcefully, Pompeo's special advisor on Iran, Brian Hook, quipped: "If you are the CEO of a European company and you are given the choice between doing business in the United States market or the Iranian market, that is the fastest decision you will ever make as CEO."(22)

With Iran pushing Europe to put in place mechanisms to counter the US sanctions, European leaders are struggling to neutralize the measures while ensuring that European entities are shielded against being barred from the US market for doing business with Iran. European authorities have so far to convince the continent's companies that they are able to do so.



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Walking a Tightrope

If the withdrawal of European companies is one indication of the difficulty in countering sanctions, SWIFT, the financial messaging system, is another. SWIFT is caught between a rock and a hard place. The Trump administration has so far refrained giving it a waiver. As a result, SWIFT's board of directors made up of representatives of major international banks risk being slapped with travel bans and asset freezes if the organization continues to do business with Iran.

To counter the US threat, the European Union invoked in July a blocking statute that makes US court decisions and administrative actions regarding sanctions on Iran void in Europe. It also prohibits Europe-based firms from discontinuing their business ties to Iran due to foreign sanctions.(23) The blocking statute was intended to not only shield European companies but also convince Iran that it was in its interests to remain committed to the nuclear accord.

"It's a difficult exercise because the weight of the U.S. in the global economy and financial system is obviously relevant. But we are determined to preserve this deal, said European Union foreign policy chief Federica Mogherini.(24) How difficult is evidenced by the fact that European measures have so far failed to produce convincing results. Without referring to the US sanctions, SWIFT said in early November that it was disconnecting an undisclosed number of unidentified Iranian banks.(25) Some 30 Iranian banks are connected to SWIFT. The impact that a disconnection from SWIFT would have was evident in 2012 when SWIFT complied with UN and EU sanctions. The disconnection wiped off almost half the value of the Iranian oil sector reducing revenues from oil exports from US$92.5 billion to USS52 billion.(26)

The odds in a US-EU battle over SWIFT are, however, not unequivocally in Washington's further. US sanctions would significantly impact the global financial system and threaten America's dominant position. "We must increase Europe's autonomy and sovereignty in trade, economic and financial policies," said. German Foreign Minister Heiko Maas.(27) Europe appears to be putting its money where its mouth is by developing a system of its own that would handle financial transactions with Iran and be immune to US sanctions. Dubbed a special purpose vehicle, the system would be open to Russia and China, both of which are signatories to the nuclear agreement, as well as other countries. European officials were also looking at a barter system that would allow Iran to sell oil and use the proceeds to purchase goods or technology from Europe.(28)

The special purpose vehicles would be designed to reduce the number of financial transactions with Iran by bundling them and to shield commercial banks by limiting their role. The advantage of multiple vehicles would allow sanctions busters to differentiate between sanctionable and non-sanctionable transactions. They could also cater to different business segments including small and medium-sized enterprises that often have no exposure to the United States, the oil industry, as well as sectors like automotive and aviation. European officials privately concede that oil traders are unlikely to avail themselves of the special vehicle(s).

The vehicles could be stand-alone state-owned banks or clearing houses for companies that transfer money to Iran, repatriate funds from the country, or engage in barter trade with it.(29) The vehicles would avoid cross-border transactions that would be easier to monitor by US authorities by arranging that a European importer of Iranian goods gets paid by a European exporter. They would further coordinate payments in ways that exporters would be paid from funds outside of Iran while importers would be paid by funds within Iran.

Iran scholar and media company owner Esfandyar Batmanghelidj and policy analyst Axel Hellman argued that Europe could kickstart its vehicle initiative which one is that is focussed on the humanitarian sector that is not included in the sanctions regime. "Companies active in food and pharmaceuticals…have the longest-standing and arguably most important presence in Iran. Companies like Nestle, Novo Nordisk, Sanofi, and Unilever—which sell the high-volume packaged foods, cleaning products, and medicines that households depend on—are at the heart of the most important commercial ecosystem in Iran, which includes Iran's private sector and its vibrant consumer class… Despite the exemptions for trade in food, medicine, and many consumer products, Iran's trade in these goods is restricted by the limited number of European banks willing to receive payments from Iranian importers. The SPV would serve to increase the volume of trade that can be conducted given the current state of banking ties," Batmanghelidj and Hellman said.(30) The European initiative is but one effort fuelled by the threat of sanctions against SWIFT to develop alternative systems including ones using blockchain, a technology that uses cryptography, that is already being considered by Russia and Iran.(31) Russia already uses a significantly cheaper alternative to SWIFT for domestic payments and is marketing it to foreign institutions.(32) China is developing a similar system.(33)

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Conclusion

The jury is out on the likely effectiveness of crippling sanctions imposed on Iran by the United States aimed at forcing the Islamic republic to alter its regional policy. Similarly, the fate of the 2015 international agreement that curbed Iran's nuclear agreement hangs in the balance after the US withdrew from the deal and re-imposed sanctions. The success of US policy and the agreement's continued viability depend on the ability of Iran's oil buyers and world powers, including Europe, China, Russia, India, Japan and South Korea to cushion the impact of the sanctions. They also depend on the degree to which the United States is forced to allow exemptions to the sanctions in its effort to balance its harsh approach towards Iran with its other geo-political concerns. The record so far suggests that Iran will endure significant pain but like in the past will be able to maintain its policy. The question is whether an opening for renewed negotiations that would address the concerns of the United States and its allies and cater to Iranian aspirations and needs will occur only when US President Trump leaves office or whether Trump may ultimately decide that talks are in the interest of both parties.

***Dr. James M. Dorsey** is a senior fellow at the S. Rajaratnam School of International Studies, co-director of the University of Würzburg's Institute for Fan Culture, and co-host of the New Books in Middle Eastern Studies podcast. James is the author of The Turbulent World of Middle East Soccer blog, a book with the same title and a co-authored volume "Comparative Political Transitions between Southeast Asia and the Middle East and North Africa", as well as "Shifting Sands, Essays on Sports and Politics in the Middle East and North Africa" and just published "China and the Middle East: Venturing into the Maelstrom".

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