

IRAN TASK FORCE

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Iran Sanctions: Preferable to War but No Silver Bullet

The Context

The broadest and toughest sanctions regime imposed on any country except Libya has not convinced Iran's leaders to abandon a program that appears aimed at developing nuclear weapons. Instead of seeking even more crippling economic penalties—such as an oil embargo—that would fracture the international consensus on Iran, the United States should tighten implementation of measures already in force and enact more sanctions linked to human rights, which have a wide constituency in Europe and demonstrate to the Iranian people that international concerns extend beyond nuclear weapons. The U.S. should also work with its diplomatic partners to craft new proposals that would couple acceptance of limited uranium enrichment with rigorous international monitoring, and encourage China, Iran's major trading partner, to use its leverage in support of nonproliferation.

The Islamic Republic has endured U.S. economic penalties since the 1979 revolution and a ban on most U.S. trade and investment since 1995. But sanctions did not really begin to bite until they became multinational, starting in 2006 and escalating dramatically in 2010, as Iran refused to abide by repeated UN Security Council resolutions requiring it to suspend enrichment of uranium. Iran also faces a raft of penalties linked to its support of groups designated by the United States as terrorist organizations. More recently, U.S. and European sanctions have been directed at individuals identified as perpetrating human rights abuses in the aftermath of Iran's 2009 disputed presidential elections.

UN sanctions bar the sale of materials Iran could use for its illicit nuclear activities and missile development as well as the sale of major conventional weapons systems; Iran is also forbidden to sell arms. Under U.S. restrictions that have had the most serious impact on the overall Iranian economy, Iranian banks cannot legally process transactions in dollars, and face increasing difficulty dealing in euros. To safeguard their U.S. interests, most Western oil companies as well as Japanese firms have frozen investment in Iran's energy sector and ended sales of refined petroleum to Iran. It is increasingly difficult for Iran's national shipping line and airline to operate internationally.

While most nations appear to have complied with UN resolutions, some Iranian trading partners—most notably China—reject so-called secondary sanctions that seek to impose penalties on foreign firms with continued involvement in Iran's oil and gas industry. China has reduced reliance on purchases of Iranian oil and slowed implementation of investments in Iran's energy sector in an apparent deal with Washington that makes it easier for the Obama administration to waive penalties against Chinese multinationals. However, China is ambivalent about Iran's nuclear progress and appears to value its relationship with a major power in the Persian Gulf more than it does its concerns about proliferation. Premier Wen Jiabao stated on October 15, 2009, that as "cooperation in trade and energy has widened and deepened" with Iran, the goal is to "promote practical cooperation between the two sides and close coordination in international affairs."¹

¹ Chris Buckley, "Chinese Premier Hails Cooperation with Iran," Reuters, October 15, 2009 (www.reuters.com/article/2009/10/15/us-china-iran-idUSTRE59E15R20091015).

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Meanwhile, rising demand for energy combined with unrest in the Middle East have contributed to higher oil prices, which compensate Iran for lost investment and stagnant or decreasing oil production. China and high oil prices are “our Achilles heel” in dealing with Iran, in the words of a senior European diplomat who spoke on condition of anonymity. The diplomat added that sanctions are still an important tool because they relieve the pressure to resort to military action against Iran, which “would make everything worse.”²

Sanctions have a large bipartisan domestic constituency in the United States in part because they are seen as a less costly alternative to military force and a means of undermining a deeply unpopular Iranian government. The toughest legislation passed in 2010; additional bills would tighten what sponsors intend to be a tourniquet around Iran’s energy sector, the source of 80 percent of Iran’s export earnings and half of government revenues. Howard Berman (D-CA), ranking member of the House Foreign Affairs Committee, has described the motivation behind such measures: “The fundamental premise of our approach is that companies should choose the U.S. market over the Iranian market. It’s a sound approach, but by no means a silver bullet for addressing Iran’s desire to acquire a nuclear weapons capability.”³

The Issue

This brief will outline the penalties imposed on Iran as a result of its nuclear program; its support for organizations the U.S. government has designated as terrorist; and its human rights abuses. It will discuss the impact of these penalties on Iran’s nuclear advancement, as well as the consequences for the overall Iranian economy. The report will note the changing makeup of Iranian trade as China, Turkey, and India supplant European countries as key economic partners. The brief will suggest greater creativity in seeking a negotiated solution of the nuclear issue, recognizing that internal political divisions may make Tehran unable to pull together a coherent or unified response. It will argue for more pressure on China, as well as a greater

emphasis on conservation and renewable energy to reduce the demand for oil. It will also recommend more penalties related to human rights, which have widespread support in Europe and among Iranians.

Three Decades of Restrictions

A visit to the Iran sanctions page of the U.S. Treasury Department’s website reveals eighteen executive orders, six laws, nineteen *Federal Register* notices, and five UN Security Council resolutions related to the Islamic Republic of Iran.⁴ The U.S. first penalized Iran—seizing its government assets in the United States—ten days after Iranian students occupied the U.S. Embassy in Tehran on November 4, 1979. Most of those assets were returned after U.S. hostages were freed, but several hundred million dollars stayed frozen and subject to arbitration by a panel in The Hague. Other U.S. sanctions—such as a ban on the sale of so-called dual-use items, as well as weapons—are tied to Iran’s designation in 1984 as a state sponsor of terrorism following the October 1983 bombing by Iran-backed Lebanese militants that killed 241 U.S. Marines in Beirut. More recent measures focus on Iran as a proliferation threat and as an abuser of human rights.

A U.S. ban on most trade and new investment in Iran, ironically, followed an Iranian offer in March 1995 of a major contract to a U.S. firm, Conoco, to develop two offshore oil fields. The offer was intended to serve as an olive branch by then Iranian president Akbar Hashemi Rafsanjani. Instead, it drew attention to the fact that U.S. oil companies were still lifting oil in Iran—albeit selling the crude outside the United States—at a time when the U.S. was advocating “dual containment” of both Iraq and Iran.⁵ (Direct U.S. imports of Iranian oil were banned by the Reagan administration in 1987.) A week after the Conoco deal was announced, President Clinton barred U.S. participation in Iran’s oil industry, and two months later, virtually all trade with Iran and new investment in the country, asserting that the “actions and policies of the Government of Iran constitute an unusual and extraordinary threat to the national security,

² Interview with the author in Washington, D.C., May 6, 2011.

³ Berman comments at a hearing of the House Foreign Affairs Committee, December 1, 2010.

⁴ “Iran Sanctions,” U.S. Department of the Treasury (www.treasury.gov/resource-center/sanctions/Programs/Pages/iran.aspx).

⁵ Barbara Slavin, *Bitter Friends, Bosom Enemies: Iran, the U.S., and the Twisted Path to Confrontation* (New York: St. Martin’s Press, 2007), p. 183.

foreign policy, and economy of the United States.”⁶ In 1999, the Clinton administration eased the ban in response to conciliatory gestures by Rafsanjani’s successor, Mohammad Khatami, to permit the sale of food and medicine to Iran. In 2000, the U.S. allowed Iran to export carpets, caviar, pistachio nuts, and other foodstuffs to the United States. However, the latter provision was rescinded in July 2010, when President Obama signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA).

CISADA, which passed the House and Senate by overwhelming margins, continues legislation dating to 1996 that threatens penalties against foreign companies that invest large sums in Iran’s energy sector. It calls for mandatory investigations of foreign companies that sell Iran gasoline and other refined petroleum products, and threatens to bar them from business in the United States. It seeks to penalize foreign banks that deal with entities connected to Iran’s Revolutionary Guards, its nuclear program, or terrorism. Given how difficult it is to prove that an Iranian bank has no such links, the bill aims to persuade foreign companies that any dealings with Iranian financial institutions will pose excessive reputational risks. CISADA also authorizes U.S. asset freezes and travel bans on Iranians deemed to be human rights abusers, a penalty previously reserved for those associated with proliferation activities.

The legislation has had a major impact on Western, Japanese, and South Korean energy firms, many of which stopped selling gasoline to Iran and froze or canceled investments in Iran’s oil and gas sector. The list includes: Royal Dutch Shell, Total, ENI, Statoil, Repsol, and Inpex.⁷ U.S. officials estimate that Iran has lost \$50 to \$60 billion in foreign investment, in part as a result of CISADA.⁸ This is investment that Iran’s aging oil fields urgently need to continue current levels of production, estimated at about 3.8

million barrels per day, and exports of about 2.4 million barrels per day. According to some experts, Iran’s oil production could fall to 3.3 million barrels per day by 2015, leaving little to export.⁹ While natural gas could compensate to some extent, Iran needs Western know-how in order to exploit its massive reserves, especially to produce liquefied natural gas.

The U.S. legislation followed passage of a fourth UN Security Council sanctions resolution on Iran—Resolution 1929—that tightened bans on the sale of major conventional weapons systems; called on foreign countries to inspect Iranian ships suspected of carrying prohibited cargo; forbade servicing such ships; made mandatory a freeze on the travel of Iranian officials linked to the nuclear program; and, for the first time, noted “the potential connection between Iran’s revenues derived from its energy sector and the funding of Iran’s proliferation sensitive nuclear activities.”¹⁰

U.S. officials have said that they do not currently seek further UN resolutions. They say there is much additional room to implement the resolution, which created a special committee to monitor enforcement.

The most effective sanctions, in the view of many U.S. and foreign officials, have been the financial restrictions imposed by U.S. Executive Orders and Treasury Department regulations. Vigorously enforced by Stuart Levey, the recently retired Under Secretary for Terrorism and Financial Intelligence, and his staff, these measures have convinced at least eighty foreign banks to cease dealing with Iran,¹¹ forced Iranian banks to end transactions denominated in dollars, even when they do not involve U.S. banks, and made it increasingly difficult to deal in euros as well. “Any foreign financial institution that conducts transactions with a number of types of [Iranian] entities is subject to being cut out from the U.S. financial system,” a senior U.S. official said. “That’s a pretty powerful tool.”¹²

⁶ “Executive Order 12957: Prohibiting Certain Transactions with Respect to the Development of Iranian Petroleum Resources,” *Federal Register*, Vol. 60, No. 52, March 17, 1995 (www.treasury.gov/resource-center/sanctions/Documents/12957.pdf).

⁷ Berman statement at a hearing of the House Foreign Affairs Committee: Implementing Tougher Sanctions on Iran, December 1, 2010.

⁸ Robert J. Einhorn, “Implementation of Iran Sanctions,” House Committee on Oversight and Government Reform, July 29, 2010 (www.state.gov/t/isn/rls/rm/145348.htm).

⁹ Kenneth Katzman, “Iran Sanctions,” *Congressional Research Service*, May 2, 2011, p. 52.

¹⁰ <http://www.treasury.gov/resource-center/Documents/1929.pdf>.

¹¹ Katzman, p. 31.

¹² Telephone interview with the author, April 27, 2011.

The banking sanctions have also been a factor in Western oil companies' decisions to wind up business in Iran. "We had trouble moving money around," said a former Tehran employee of a Western oil company. "The range of challenges was so broad, like a dam with holes. At the end of the day, you run out of fingers to plug the holes."¹³

The banking sanctions, however, have had an adverse effect on ordinary Iranians seeking to transfer funds, and on private businesses attempting to obtain letters of credit. U.S. companies legally permitted to sell food and medical items to Iran—under a so-called "humanitarian exception"—report difficulties in processing transactions, even after obtaining the necessary licenses from the Treasury Department's Office of Foreign Assets Control. A broker for medical items said it was necessary to use currency exchangers who charge high fees for processing wire transactions through the limited number of banks still willing to deal with Iran.¹⁴ The result, the broker said, is harm to ordinary Iranians and U.S. businesses that seek to maintain limited contact with Iran. Total U.S.-Iran trade in 2010 was worth \$300 million, half of what it was in 2008.¹⁵

Members of Congress, while expressing some satisfaction with the impact of U.S., European, and multinational sanctions, have introduced or are planning additional legislation that would punish foreign oil companies that sign long-term contracts with Iran. The ultimate goal, congressional staffers say, is to cripple the Iranian energy sector in a gradual way that would not increase pressures on already-high oil prices.

Mark Dubowitz, executive director of the Foundation for Defense of Democracies, a Washington policy institute whose research has informed many congressional sanctions proposals, said, "The goal is to cut the amount of revenue flowing to the Iranian treasury. . . . If you can massively increase the hassle factor, you can persuade certain companies to step away from Iranian crude and provide leverage to those still buying to get discounts."¹⁶

Other bills that may be considered by Congress this year would seek to end World Bank loans to Iran; bar U.S. visas for CEOs of foreign multinationals that continue to do business with Iran; oblige the Obama administration to appoint a special representative on human rights and democracy in Iran (the United Nations has already appointed a special rapporteur on Iranian human rights); require the administration to produce a comprehensive strategy to promote Internet and other access to information in Iran; and penalize companies that sell products or services that could help the Iranian government repress and spy on its citizens.¹⁷

Europe Pivots Over Human Rights

For years, U.S. officials have lobbied European governments and companies in vain to cut back on economic ties with Iran. Washington waived penalties under the Iran and Libya Sanctions Act of 1996 and successor laws—which sought to penalize foreign companies investing significant sums in Iran's energy sector—after negotiating tougher European Union rules on the transfer of dual-use products to Iran. However, U.S. measures chiefly penalized American businesses and had little impact on the Iranian economy. That picture began to change after the International Atomic Energy Agency (IAEA) referred Iran to the UN Security Council in 2006, following Iran's resumption of a uranium enrichment program in the aftermath of failed negotiations with Britain, France, and Germany. The most dramatic shift came after Iran's disputed 2009 presidential elections. The Iranian government's massive crackdown following the tainted victory of incumbent president Mahmoud Ahmadinejad—marked by hundreds of deaths and thousands of arrests of peaceful protestors and civil society activists—for the first time provided strong political backing in Europe for tougher measures against Tehran.

European diplomats acknowledge the role that human rights abuses have played in persuading European governments to penalize Iran. "It's politically easier [to impose sanctions based on human rights]," said the senior European diplomat.

¹³ Telephone interview with the author, May 12, 2011.

¹⁴ Telephone interview with the author, May 5, 2011.

¹⁵ Katzman, p. 28.

¹⁶ Telephone interview with the author, April 28, 2011.

¹⁷ Josh Rogin, "Congress Preparing Series of New Iran Sanctions Bills," *Foreign Policy*, May 3, 2011 (http://thecable.foreignpolicy.com/posts/2011/05/03/congress_preparing_series_of_new_iran_sanctions_bills).

“Some European politicians have built their careers on human rights, and such measures are seen as far preferable to military action.”¹⁸

Since 2010, Europe has imposed asset freezes and travel bans on thirty-two Iranians accused of human rights abuses—three times the number designated by the United States. At the same time, European companies have begun to wind down investment in the Iranian energy sector. Following passage of UN Resolution 1929, the European Union banned the transfer of technology and other assistance to Iran’s oil and gas industry—measures not required by the resolution. “The Iranians were genuinely shocked when the EU did exactly what we said we would do,” an EU diplomat in Washington said.¹⁹

The former Tehran employee of a European oil company said that moves to leave the Iranian market began prior to the 2009 elections, as European firms faced growing challenges when making and receiving payments, insuring shipments, and procuring materials. However, postelection events convinced European companies that “the pressure the U.S. was putting on European countries would be more and more difficult to resist. European governments could not argue anymore that Iran was about to reform. By late 2009, most companies saw the writing on the wall.”²⁰

Sanctions have had an adverse impact on European businesses. The Spanish oil company Repsol left behind an investment of \$4 billion in Iran, the EU diplomat noted. Small companies in Germany have suffered from a decline in government export credits to Iran. As Europe cut back, however, Chinese companies came in. Collectively, the twenty-seven nations of the European Union remained Iran’s biggest trading partner in 2009, but China took a greater percentage of Iranian exports and nudged out Germany as a major source of Iranian imports.²¹

China’s “Dual Game”

Numerous studies of sanctions have shown that they must be truly comprehensive and multilateral to achieve the desired results—especially when the goals are as ambitious as they are with Iran. As the possessor of the world’s third-largest proven oil reserves and second-largest gas reserves, Iran is difficult to isolate, particularly for a country with such gargantuan energy appetites as China.

China was Iran’s largest export partner in 2009, taking in 16.5 percent of Iranian exports, primarily oil.²² China has also become the largest investor in Iran’s energy sector, accounting for \$30 billion in deals in 2009, according to John W. Garver, an expert on Chinese-Iranian relations at the Sam Nunn School of International Affairs at the Georgia Institute of Technology.²³

In September 2010, the Foundation for Defense of Democracies identified ten Chinese companies that it said should be investigated for U.S. sanctions under CISADA.²⁴ In March of this year, ten U.S. senators sent Secretary of State Hillary Rodham Clinton a letter asking for the status of U.S. investigations into five Chinese energy companies said to be investing in or selling gasoline to Iran in violation of CISADA, including the China National Offshore Oil Corporation, the China National Petroleum Corporation, and Sinopec.²⁵ So far, the Obama administration has sanctioned nine companies under the law but no Chinese firms, even though China supplies a third of Iran’s gasoline imports according to the Foundation for Defense of Democracies.

U.S. officials respond to charges of picking low-hanging fruit by noting that China has reduced imports of Iranian oil and slowed implementation of contracts. A former U.S. official said that an understanding had been reached in late 2010 under which China would freeze investment in Iran’s energy sector in return for the U.S. waiving CISADA penalties.²⁶

¹⁸ Interview with the author in Washington, D.C., May 6, 2011.

¹⁹ Telephone interview with the author, May 4, 2011.

²⁰ Telephone interview with the author, May 12, 2011.

²¹ “Background Note: Iran,” U.S. Department of State, February 17, 2011 (www.state.gov/r/pa/ei/bgn/5314.htm).

²² Ibid.

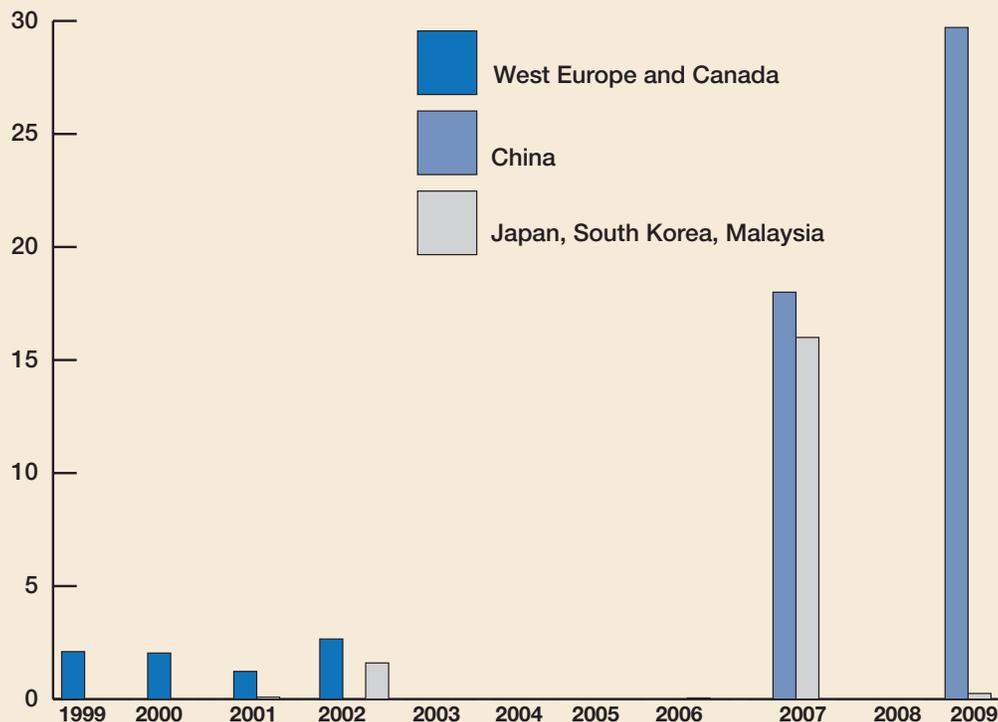
²³ See chart provided by Garver.

²⁴ Mark Dubowitz and Laura Grossman, “Iran’s Chinese Energy Partners: Companies Eligible for Investigation Under U.S. Sanctions Law,” Foundation for Defense of Democracies, September 2010 (www.iranenergyproject.org/documents/1674.pdf).

²⁵ March 10, 2011, letter to Clinton, provided by a Senate staffer.

²⁶ Interview with a former U.S. official in Washington, D.C., May 3, 2011.

Investment in IRI Oil and Gas, 1999-2009



Credit: John W. Garver, Sam Nunn School of International Affairs, Georgia Institute

According to Chinese customs figures, Chinese imports of Iranian oil fell by 7.9 percent in 2010, although Iran remains China's third-largest supplier, providing 8.9 percent of China's total oil imports. There is some evidence that China may be altering its supply sources. Chinese imports from Angola—China's second-largest supplier—grew in the same period by 22.4 percent; from Saudi Arabia, by 7 percent; from Oman, by 35.2 percent; from Iraq, by 56.9 percent; and from Kazakhstan, by 67.4 percent, according to Garver. As a result, China now imports nearly 19 percent of its oil from Saudi Arabia, more than 16 percent from Angola, and substantial quantities from other U.S. allies and non-adversaries.²⁷

But if China is cutting back in response to U.S. entreaties, it is not about to abandon Iran. "China views Iran as an important country in part because of oil, and because Iran is

arguably the major power in that region," Garver said. "It's ambitious and coherent and able to mobilize resources for national purposes and to take risks. . . . China's take on sanctions toward Iran is that they won't work, and of course, China has kept them weak so that they don't work."²⁸

Garver has argued that China is playing a "dual game," seeking to retain access to "Iran's fabulously rich but still largely unexploited oil and gas resources to meet China's skyrocketing demand for imported energy," while also trying to stay on good terms with the U.S., in order "to maintain a favorable macro-climate for China's development drive." Garver also said that some elements in China would actually prefer Iran to develop nuclear weapons, because "a strong Iran resistant to U.S. dictates and at odds with the United States would force Washington to keep large military forces in the region, limiting the ability of the United States to

²⁷ E-mail to author, April 29, 2011.

²⁸ Telephone interview with the author, April 29, 2011.

concentrate forces in East Asia, where China's core interests lie."²⁹

David Shambaugh, a China scholar at George Washington University, said he doubts that China would approve additional UN sanctions. "The Chinese have gone as far down the coercive path as they want to go," he said. "In the abstract, they don't want a nuclear-armed Iran, but it doesn't really affect their national security one way or the other if Iran has the bomb or not."³⁰

U.S. diplomatic cables released by WikiLeaks underscore Chinese reluctance to abandon energy ties with Iran. A March 2008 cable quotes Chinese arms control director-general Cheng Jingye as telling Senate Foreign Relations Committee East Asia specialist Frank Jannuzi 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." Cheng went on to say that "the threat of sanctions against Sinopec is a very serious issue. . . . Sinopec is very important to China, and Cheng 'can't imagine' the consequences if the company is sanctioned."³¹

The relationship goes far beyond energy. Both Garver and Shambaugh note that there are a large number of delegations that go back and forth between China and Iran, including cultural, sports, and provincial groups. "If the rest of the world is trying to isolate Iran, China's doing just the opposite," Shambaugh said.

While China is a major impediment to isolating Iran, Turkey and India are also resisting U.S. pressure to cut economic ties. Major suppliers of refined petroleum products in both countries—India's Reliance and Turkey's Tupras—have stopped sales to Iran in deference to CISADA. However, Turkey gets nearly half its energy supply from Iran, and India,

nearly 20 percent, although India is facing difficulties finding a way to pay for the oil due to banking sanctions.

Turkish prime minister Recep Tayyip Erdogan said last year that Turkey intends to triple its trade with Iran, from \$10 billion annually to \$30 billion over the next five years.³²

"Nobody can ask us to stop our economic ties with Iran," Turkish foreign minister Ahmet Davutoglu said. "We will continue to have these ties because it is in our national interest."³³

Slower Progress on Enrichment

Beyond banking restrictions and efforts to squeeze Iran's energy sector, multilateral measures to impede Iranian access to materials and equipment that can be used for its nuclear program are also having an impact—although cyber warfare, defections, and assassinations of nuclear scientists are arguably equally if not more effective. According to nuclear experts, Iran is facing difficulties building centrifuges, the spinning machines that enrich uranium. While the Iranians have installed about 8,000 P-1 centrifuges at its main known facility in Natanz, only 5,000 are actually working at any given time. Iran also seems to be having problems building and installing a more-advanced model of centrifuge at a pilot plant in Natanz.

David Albright, a former UN nuclear inspector and president and founder of the Institute for Science and International Security, said the Iranians are having trouble obtaining the maraging steel and carbon fiber needed to construct centrifuges, as well as vacuum pumps, piping, and measuring equipment.³⁴ Even when Iran is able to purchase such items, it faces the danger that shipments will be intercepted. A recent report by a UN panel of experts said sanctions were "constraining" Iran's procurement, but that

²⁹ John W. Garver, "Is China Playing a Dual Game in Iran?," *The Washington Quarterly*, Winter 2011 (www.twq.com/11winter/docs/11winter_Garver.pdf).

³⁰ Telephone interview with the author, May 5, 2011.

³¹ Cable 08Beijing1141: Jannuzi Discusses Nonproliferation, Iran (<http://wikileaks.ch/cable/2008/03/08BEIJING1141.html>).

³² Thomas Grove, "Turkey's PM Tells Businessmen to Boost Iran Trade," Reuters, September 16, 2010 (www.reuters.com/article/2010/09/16/turkey-iran-trade-idUSLDE68F18F20100916).

³³ Colum Lynch, "Turkey's Foreign Minister: Thanks, but No Thanks, on Iran Sanctions," *Foreign Policy*, September 23, 2010 (http://turtlebay.foreignpolicy.com/posts/2010/09/23/turkeys_foreign_minister_thanks_but_no_thanks_on_iran_sanctions).

³⁴ Telephone interview with the author, April 25, 2011.

Iran continued to find ways to circumvent sanctions by using “front companies, concealment methods in shipping, financial transactions, and the transfer of conventional arms and related materiel.”³⁵

Iran continues to make slow progress. “They are building their capabilities, improving slightly capacity in all areas—enrichment, heavy water, and enrichment [of uranium to 20 percent] for the Tehran Research Reactor,” said Olli Heinonen, former deputy director-general of the International Atomic Energy Agency (IAEA). “There is no way sanctions can stop such a thing, but it makes it more costly and more difficult.”³⁶

U.S. officials have said that they do not believe that Iranian leaders have made a decision to produce nuclear weapons. Heinonen said it made no sense for Iran to proceed down that path while its capacity remains limited. “You can only go in that direction when you really have all the ingredients in place,” he said.

While there still appears to be time to reach a diplomatic solution—recent estimates suggest Iran could not build a bomb until 2015 at the earliest³⁷—diplomacy has stalled in part due to Iranian political infighting. A confidence-building measure backed by the United States, the other permanent members of the UN Security Council, and Germany—the so-called P5+1—would require Iran to ship out the bulk of its stockpile of low-enriched uranium (LEU) for conversion abroad into fuel for the Tehran Research Reactor, which makes medical isotopes. Iran, after first appearing to accept the proposal in October 2009, backed down when it was harshly criticized by domestic opponents of President Mahmoud Ahmadinejad. In May 2010, after mediation by Turkey and Brazil, Iran agreed to send out 1,200 kilograms of LEU, but this no longer represented a sufficient percentage

of its stockpile to provide confidence that Iran lacked the fuel to build a weapon.

At the most recent talks, in Istanbul in January, Iran demanded that the P5+1 first accept Iran’s right to enrich uranium and agree to lift all sanctions before it would resume negotiations—demands that were understandably rejected.³⁸ Meanwhile, Iran has begun to produce its own fuel for the Tehran reactor. An Iranian official said recently that Iran had produced 40 kilograms of uranium enriched to 20 percent of U-235, the isotope whose atoms can be split to release large amounts of energy. The official said Iran would enrich another 80 kilos by next March, suggesting that Tehran was no longer interested in any confidence-building deals.³⁹ Still, another round of talks is possible this summer. Iranian chief nuclear negotiator Saeed Jalili, responding to a letter from EU foreign policy chief Catherine Ashton, said Iran would return to the table provided that “the talks [would] be just and with no pressure exerted.”⁴⁰ President Ahmadinejad was more forthcoming in a recent interview with Iranian television, saying Iran was “ready for dialogue” on the nuclear issue. So far, however, U.S. and European officials appear to be regarding Iran’s latest show of interest as a ploy. A spokesperson for Ashton said that Jalili’s response to her letter “does not contain anything new and does not seem to justify a further meeting” between Iran and the P5+1.⁴¹

How Sanctions Impact the Iranian Economy

Iranian officials frequently disparage sanctions and assert that Iran will never give in to foreign pressure. Still, sanctions have harmed the Iranian economy, depressing investment in the energy sector and empowering Iran’s major trading partners to demand discounts on energy and other deals.

³⁵ Colum Lynch, “Iran’s Nuclear Program Still Trying to Overcome International Sanctions,” *The Washington Post*, May 11, 2011 (www.washingtonpost.com/world/irans-nuclear-program-still-trying-to-overcome-international-sanctions/2011/05/11/AFsfBjtG_story.html).

³⁶ Telephone interview with the author, May 1, 2011.

³⁷ Yossi Melman, “Outgoing Mossad Chief: Iran Won’t Have Nuclear Capability before 2015,” *Haaretz*, May 9, 2011 (www.haaretz.com/print-edition/news/outgoing-mossad-chief-iran-won-t-have-nuclear-capability-before-2015-1.335656).

³⁸ Robert J. Einhorn, “The Impact of Sanctions on Iran’s Nuclear Program,” speaking before the Arms Control Association, March 9, 2011 (www.armscontrol.org/events/RoleSanctionsIranNuclear).

³⁹ “Nuclear Fuel for Tehran Reactor Will Be Ready by March 2012,” *Tehran Times*, April 28, 2011 (www.tehrantimes.com/index_View.asp?code=239572).

⁴⁰ Parisa Hafezi and Reza Derakhshi, “Iran Tells EU’s Ashton Next Atom Talks Must Be ‘Just,’” Reuters, May 10, 2011 (<http://af.reuters.com/article/worldNews/idAFTRE7491N820110510>).

⁴¹ “Ahmadinejad Insists Iran Ready for Nuclear Talks,” Agence France Presse, May 15, 2011 (http://news.yahoo.com/s/afp/20110515/wl_mideast_afp/irannuclearpolitics).

Increasingly dependent on China, Iranians complain that China is dumping inferior goods in the Iranian market, taking advantage of Iran's constricted choices and forcing domestic producers out of business. However, the sanctions have had a silver lining in one important respect: They helped the government justify pushing through a major program of subsidy reforms in December.

Specialists on the Iranian economy praised the move—which Ahmadinejad's predecessors had wanted but failed to implement—as necessary to diminish demand, reduce waste, and balance the budget. Subsidies on items ranging from gasoline to milk have cost the Iranian government between \$70 and \$100 billion a year, and reduced the amount of oil available for export. Ahmadinejad cushioned the blow to consumers by giving middle- and working-class Iranians about \$90 in cash to cover the first two months of the reforms, thus averting massive protests. However, the handouts are boosting inflation, and early indications are that the government is spending more money on cash payments than it is saving.

Djavad Salehi-Isfahani, an expert on the Iranian economy at Virginia Tech and the Brookings Institution, said many Iranians have been shocked by the increase in prices, as they only recently received unsubsidized utility bills. "People are upset because they thought the handouts were for them to keep, not to pay the bills," he said. "So they went and spent the money on things like LCD televisions, and when the bills came, they didn't have the money."⁴²

Higher energy prices are forcing inefficient factories out of business, which may make sense from a macroeconomic view, but actually increases unemployment—already in the double digits, and as high as 70 percent among Iranian youth.⁴³ Inflation, officially at 12 percent, is actually at least 20 percent, Salehi-Isfahani said. While Iran reports ample foreign exchange reserves of about \$100 billion, it is basing its next budget on an oil price of \$81.50 a barrel—historically high—risking major economic difficulties if the price falls below that level.⁴⁴

A recent intensification of political infighting between Ahmadinejad and Iran's supreme religious leader, Ayatollah Ali Khamenei, is contributing to a mood of anxiety among domestic investors. "The economy is not moving forward," Salehi-Isfahani said. "I suspect that IMF predictions of near zero growth this year will hold." Given that the subsidy reform program is so identified with Ahmadinejad, Salehi-Isfahani added, if the president is seen as politically weakened, "people are going to make all kinds of assumptions about whether the money will come or not . . . The whole program is in a very fragile state at this point."

Meanwhile, sanctions imposed by the United States are creating hardship for the Iranian middle class, inhibiting travel and remittances from family members. Even though CISADA permits limited sales of jet fuel, many European companies—fearing a backlash on their much more lucrative American interests—have refused to service Iran Air. Iran has retaliated against European airlines, many of which must now refuel outside Iran. CISADA also contains a provision exempting humanitarian trade with Iran. However, Americans who broker sales of food and medical items to Iran report difficulties in finding third-country banks to process the transactions.

Western companies that provide a range of consumer goods and services have quit the Iranian market even though their products have nothing to do with the nuclear program. At a congressional hearing last year, Under Secretary of State William Burns noted that "Daimler, Toyota and Kia have stopped exporting cars to Iran." Levey, testifying at the same hearing, added that "major companies across a range of industries—finance, engineering, energy, manufacturing, automobile, insurance, accounting firms—they are all announcing that they're curtailing their business dealings with Iran."⁴⁵

Sanctions have increased the role of the Revolutionary Guards in the Iranian economy, as they have picked up contracts that would otherwise have gone to foreign firms. Since the Guards are already the subject of multiple U.S.

⁴² Telephone interview with the author, May 7, 2011.

⁴³ Dariush Zahedi and Hamed Aleaziz, "Iran's Blue-Collar Revolution," *Foreign Policy*, April 6, 2011 (www.foreignpolicy.com/articles/2011/04/06/irans_blue_collar_revolution).

⁴⁴ "Iran Hikes Budget by 31% amid High Oil Revenues," Agence France Presse, May 11, 2011 (www.google.com/hostednews/afp/article/ALeqM5jmYaMb7K_9tKpVv7-ts2StSVTrAQ?docId=CNG.a6e23f58edf0879da98617c7bf6239a9.421).

⁴⁵ Levey testifying before the House Foreign Affairs Committee hearing: Implementing Tougher Sanctions on Iran, December 1, 2010 (<http://foreignaffairs.house.gov/111/62665.pdf>).

and UN sanctions over the nuclear program and terrorism, this expands the target list for foreign penalties.

It is difficult to know whether Iranians blame their government for the sanctions. Opinion polls suggest that most Iranians believe their country has a right to nuclear energy technology, but it is not clear whether they feel that the price Iran has paid for its nuclear program is too high. Some Iranian political dissidents who once opposed sanctions appear to have changed their positions in the aftermath of the 2009 presidential elections. Asked about the issue during a recent appearance in Washington, Nobel Peace Prize laureate Shirin Ebadi declined even to use the word “sanctions,” referring to the measures as “laws regarding trade.”

“What has America done? America has limited the work of corporations within its borders. It has said that countries that have over a million transactions with Iran will not be able to continue their work here—in America. Legally, this is not a sanction. This is regulating trade in America. We may not like it, but it’s not sanctions. Now, this depends on big corporations; they have the right to choose whether they want to work in Iran or America. Therefore, as a defender of human rights I cannot speak in this regard; it’s the corporations that have to determine what to do.”⁴⁶

Beyond Sanctions: A Revised Approach

U.S. officials frequently assert that, as Under Secretary of State Burns told Congress last year, “sanctions and pressure are not an end in themselves; they are a complement, not a substitute, for the diplomatic solution to which we and our partners are still firmly committed.”⁴⁷ However, sanctions have become the instrument of choice in dealing with Iran, and are likely to remain so barring a dramatic shift in Iranian policies. For a United States embroiled in three foreign conflicts, sanctions have particular appeal as a substitute for another Middle East war, and as a way for members of Congress to show constituents and lobby groups focused on the issue that they are doing *something* about Iran.

“Sanctions were never supposed to become an end [unto] themselves, but unfortunately they can easily become so, because they are something we know how to do,” said John Limbert, the former top State Department official dealing with Iran. “Changing relations with Iran is much harder [than imposing sanctions]—particularly if the other side is not going to be very cooperative.”⁴⁸

Scholars of sanctions note that they rarely work if the goal is not clearly defined; they fear that Iran will balk at curbing its nuclear program unless it has a better sense of what it can expect in return. While all UN sanctions resolutions on Iran include an annex restating a wide-ranging multinational offer of economic cooperation, first tabled in 2008, many of the other penalties imposed on Iran are tied to issues such as terrorism and human rights, and would not be lifted so long as Iran supports groups such as Hezbollah and Hamas, and continues to oppress its own people.

Still, it might be possible to affect Iranian calculations about the nuclear program if the international community were willing to spell out clear guidelines for uranium enrichment. “It used to be that not having enrichment was one of the goals [of sanctions], but is it realistic now?” asked Kimberly Elliott, a specialist on sanctions at the Center for Global Development. “What is acceptable for the U.S. and EU may not be within the range of acceptable” for Iran.

Piling on yet more stringent and comprehensive penalties—seeking to embargo Iranian oil exports, for example—risks undermining the significant international cooperation the Obama administration has achieved without giving adequate time for the sanctions already imposed to work. “If you push too far, you risk undoing a lot of what they have been able to accomplish,” Elliott said. “If we go for a complete embargo, you’re going to lose everything.” Such an embargo would add to pressures on an oil market already roiled by unrest in the Middle East, including reduced production by Libya. The higher the oil price goes, Elliott added, “the less likely that countries outside the U.S. will be willing to embrace any stronger sanctions particularly targeted at the energy sector.”

⁴⁶ Ebadi spoke at the Carnegie Endowment for International Peace, Washington, D.C., April 21, 2011 (http://carnegieendowment.org/files/Ebadi_transcript.pdf).

⁴⁷ Burns testified at the House Foreign Affairs Committee hearing: Implementing Tougher Sanctions on Iran, December 1, 2010 (<http://foreignaffairs.house.gov/111/62665.pdf>).

⁴⁸ Barbara Slavin, “Hostage to Events,” *Foreign Policy*, July 27, 2010 (www.foreignpolicy.com/articles/2010/07/27/hostage_to_events).so long as China maintains close economic ties with Iran and the price of oil remains stubbornly high.

To maintain the widest possible international cooperation, the United States should work with its diplomatic partners to craft new options for the Iranian nuclear program beyond the Tehran research reactor proposal, which appears to have been overtaken by events. Condoning limited enrichment to a level of 5 percent U-235 could be coupled with demands that Iran agree to rigorous monitoring, including ratification of the Additional Protocol to the Nuclear Non-Proliferation Treaty. If Iran refuses, the international consensus against it will only be strengthened.

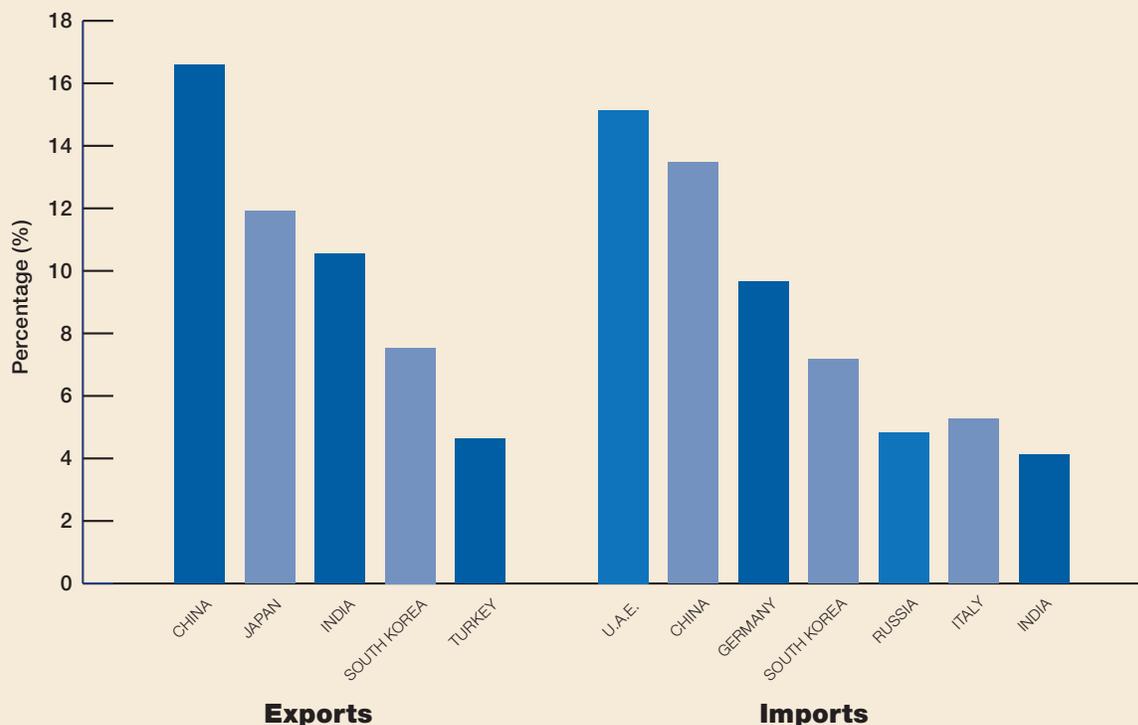
The U.S. Treasury Department should publicly declare that it does not want sanctions to adversely affect ordinary Iranians by impeding the provision of humanitarian goods, preventing Iranians in the diaspora from sending remittances to relatives, or making it even more difficult for civil society organizations—including those that promote democracy for Iranians—to operate. (One model for such changes would be U.S. relaxation of sanctions on such activities with Cuba.) Forcing payments into the shadowy world of currency exchangers only makes transactions less transparent.

Especially given the importance of human rights in the dynamic changes now sweeping the Middle East, the U.S. should focus on this area for any future sanctions, singling out those individuals and institutions most responsible for the repression of Iranian citizens. These measures have wide support within Iranian society, and would show that the United States is not focused solely on the nuclear program, which has less resonance for the Iranian people.

If sanctions are to succeed, China must be persuaded to use its growing economic leverage to convince Iran to accept a diplomatic resolution of the nuclear issue. It is in China's best interest as a rising great power to show that it has the ability to broker such deals, and that commerce, domestic economic growth, and bogging down the U.S. military in the Middle East are not Beijing's only preoccupations.

Finally, the United States should lead the way in conservation and in developing sources of renewable energy in order to diminish the power of oil producers like Iran to defy the international community—not to mention alleviating the climate change that threatens the entire planet.

Iran's Major Trading Partners (as of 2009)



Data Source: State Department Country Background Report

Conclusion

The Obama administration has made remarkable progress in unifying the international community behind tough sanctions on Iran, but it has not achieved its goal of persuading Tehran to curb its nuclear program. Like a frog in a pot of water that is gradually getting hotter, Iran has adjusted to sanctions and even benefited by lifting consumer subsidies that distorted its economy. It is unlikely that the water will reach its boiling point so long as China maintains close economic ties with Iran and the price of oil remains stubbornly high.

The U.S. should work with the other members of the P5+1 to reach a common stance on uranium enrichment that would allow Iran to save face while alleviating proliferation concerns. Instead of proposing more measures to cripple the overall

Iranian economy, Washington should concentrate on implementing current sanctions, focus on Iran's human rights abuses, and press the Iranian government to embrace its people's demands for greater freedom and democracy.

Iran is not immune to the democratic currents sweeping the region. Indeed, Iranian young people led the way with unprecedented protests in 2009. The best solution to the Iranian nuclear crisis is a more-representative Iranian government, which would be better equipped to make decisions that are truly in the best interests of the Iranian people, as well as the wider world. That political evolution, however, cannot be imposed from the outside; it must come from the Iranians' own efforts.

June, 2011

About the Atlantic Council's Iran Task Force

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

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