

Will Sanctions Change Iran's Nuclear Calculus?

Written by Javad Heydarian

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JAVAD HEYDARIAN, JUN 11 2012

Iran is currently under one of the most comprehensive and punitive set of sanctions ever implemented in history. So far, the country has withstood the impact of unilateral Western sanctions, but with the European Union's (EU) oil embargo and new U.S. sanctions set to take effect in coming days, Tehran will be put under tremendous economic pressure.

Ostensibly, the main goal of the sanctions is to prevent Iran from pursuing nuclear weapons. By progressively raising the economic costs of unrestrained uranium enrichment, the West hopes that Tehran will be forced to modify its nuclear position, come to the negotiating table, and strike a compromise with the world powers (the so-called P5+1). Specifically, the sanctions aim at achieving four main objectives: (1) transparency and more rigorous inspection; (2) non-diversion of fissile material; (3) transfer of high-grade uranium stockpiles to a third-country; and, (4) continued confidence-building measures to ascertain the exact nature of Iran's nuclear program.

Yet sanctions alone do not constitute a strategy – their utility is purely tactical. There are only two alternative strategies to approach the Iranian nuclear conundrum: diplomacy and military intervention. Clearly, as the military option is neither desirable nor urgent, the world powers prefer a peaceful resolution of the issue through diplomatic compromise. In the meantime, while the sanctions have brought Iran back to the negotiating table, there has not yet been any concrete indication of a fundamental shift in the negotiating positions of both Iran and the West. There is a serious deadlock in the ongoing negotiations: while Iran's main goal is to fend off sanctions, the West refuses to negotiate the reversal of sanctions in exchange for greater Iranian cooperation. If this deadlock is not immediately resolved, the talks could irreversibly collapse and the situation could dramatically escalate.

As pending sanctions come into effect (and more punitive proposed sanctions loom on the horizon), the hardliners in Tehran could gain the upper-hand in the country's divided internal politics, undermine the tenuous consensus on the need for compromise, and push for a more defiant and uncompromising position, which, in turn, could strengthen the hands of Western hawks who have been advocating for the use of the military option.

The Dual-Track Approach

The expressed strategy of the West is the so-called 'dual-track approach': intensifying sanctions while pressing for compromise at the negotiating table. However, the present focus is much more on the sticks than on the carrots. In the past (2003-2005), the Europeans offered more enticing incentives: provision of light water power plants, financial assistance and investment, and favorable trade agreements. In contrast, the West's recently offered incentives are comparatively miniscule: provision of spare parts for civilian aircraft, cooperation on nuclear safety, and assistance in the energy sector. There is neither a concrete discussion on the provision of medical isotopes nor a coordinated and explicit recognition of Iran's right to low-grade enrichment in accordance with the provisions of the Non-proliferation Treaty (NPT).

The emerging preference among Western powers for a more intensive sanctions regime rests on a perception that diplomacy alone will simply allow Iran to buy more time to push the boundaries of its enrichment program (although the Iranian nuclear program has steadily progressed despite the sanctions and there has arguably never been serious diplomatic engagement on this matter).

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There is also an element of domestic politics coming into play, especially in Washington, where President Obama is battling for his re-election. Facing growing political pressure from the Republicans and the Israeli lobby, the Obama administration is scrambling to show concrete results on the negotiation front. His strategy is clear: emphasis on a cocktail of sanctions and direct engagement, with an implicit threat of military intervention if Iran actively pursues a nuclear-weapons capability.

The West feels that there is time for diplomacy, because there is a consensus among the world's leading intelligence agencies that Iran has neither created a decision-making structure around a nuclear weapons program nor developed a reliable delivery system to deploy any prospective nuclear warheads. The cost of intervention could also be incalculable: Iran has considerable defensive capabilities and the ability to expand the theatre of conflict by activating its wide network of proxies across the region.

In addition, Iran can also choose to destabilize the global energy markets by mining and targeting the Strait of Hormuz, through which almost 40 percent of global seaborne oil passes. This can push the oil price to \$160-\$200 per barrel of oil, effectively choking off a troubled global economy. Due to ongoing tensions with Iran, the price of Brent crude is currently more than \$120 a barrel — the highest it's been in almost 150 years. Consequently, the American electorate has been demanding more decisive action from their government. This means that the Obama administration has the unenviable task of simultaneously pushing for diplomatic success on the one hand, and preventing an escalation in Iran-West tensions on the other. Obama's dilemma lies in the fact that he can neither make any major concession in negotiations (lest he come under fire by hawks), nor can he allow the negotiations to break down (because it can pave the way towards a destructive conflict).

The Anatomy of the Sanctions

Since its inception, Iran has come under a myriad of international sanctions. Among the earlier sanctions, the most consequential were the American-led restrictions on direct oil trade with and investment in the Iranian energy sector, partly explaining the continued Iranian difficulty with upgrading refinery capacity and developing largely untapped natural gas reserves. Since 2006, after the collapse of nuclear negotiations in 2005, the United Nations Security Council (UNSC) has imposed a series of sanctions against the individuals involved in various aspects of Iran's nuclear and ballistic programs. However, the most crucial set of sanctions are those recently imposed by the E.U. and the U.S. targeting Iran's economic lifelines: oil exports and the Iranian Central Bank (*Bank-e-Markazi*). Facing vehement Chinese and Russian opposition to any serious UNSC-approved sanctions against Iran, the West chose to push forward with an unprecedented unilateral sanctions regime.

Arguably, what triggered (or facilitated the introduction of) the latest round of sanctions was an International Atomic Energy Agency (IAEA) report, released in November last year, alleging that Iran engaged in clandestine weapons-related nuclear research. The release of the report was followed by intensive transatlantic talks on coordinated economic measures against Iran. Within two months, the E.U. and the U.S. signed their new economic sanctions into law. These efforts were followed by intensive discussions with Arab oil exporters to compensate for reductions in Iranian crude supply.

The E.U.—traditionally, Iran's largest economic partner—has had tremendous economic leverage over Tehran for a number of reasons: (1) The bloc has been a destination for more than a quarter of Iran's total oil exports; (2) Iran has had substantial financial investments in European banks; (3) The bloc hosts around three-quarters of the world's shipping insurance firms; (4) Europe has been a key source of high-end technology, capital, and investment in critical areas such as manufacturing and energy; and lastly, the bloc hosts the world's main network responsible for facilitating international financial transactions, namely the Society for Worldwide Interbank Financial Telecommunication (SWIFT). The E.U. is not only set to impose a blanket embargo on Iranian oil imports starting July 1, but it has also placed sanctions on Iran's Central Bank, financial assets, ports, shipping industry, and, crucially, insurance for Iranian crude exports—complicating Iran's trade with all its customers.

The American sanctions on Iran's energy sector and trade have also been consequential. Although Washington has no direct trade with Iran, it has used its influence to convince the SWIFT to expel Iran while pressuring Iran's non-

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Western partners, from Turkey to India, China, Singapore and the United Arab Emirates, to stop assisting Iran with refined-petroleum imports and any large-scale, dollar-denominated financial transactions lest they face American sanctions. Moreover, the Americans have also used the threat of sanctions to force Iran's top oil customers, from South Korea to India and Japan, to cut their Iranian oil imports in order to gain waivers of exemption. Otherwise, culpable Asian companies would be barred from receiving US export licenses, US Export-Import Bank financing, and loans over \$10m from US financial institutions. In effect, the U.S. has forced these countries to choose between doing business with America or Iran. America has already imposed sanctions against certain Chinese, Singaporean, and Emirati companies.

The sanctions' timing is also crucial. Since late 2010, Iran has been engaged in a massive subsidy-reform program to cut wasteful energy consumption and streamline government expenditures. So, naturally, the prices of many essential basic commodities have risen to new heights. In addition, Iran's loose monetary policy – below-inflation interest rates – and occasional diplomatic spats with key trade partners such as the UAE have contributed to the uncertainty in the Iranian economy, which is already experiencing a downward trend in annual GDP growth. The consequence has been a gradual and noticeable rise in inflation, growing uncertainty in equity markets, and a steady drive into speculative capital as well as gold and foreign currency markets. In effect, the sanctions compounded already-present economic uncertainties.

The Ambiguity of the Sanctions' Efficacy

In theory, the sanctions are supposed to specifically target the Iranian regime, depriving it of the revenue necessary to fund its nuclear program and related activities, but with the ever-growing scope and intensity of unilateral Western sanctions, the entire Iranian economy is effectively under siege. As a result, Iran is finding it increasingly difficult to not only sustain its oil exports of around 2.2 million barrels/day – constituting around three-quarters of the state's total revenue – but also in conducting cost-effective, reliable international financial transactions on a large scale.

Already, the International Monetary Fund (IMF) has made a downward revision of Iran's 2012 (nominal) growth outlook, from a high of 2.5 percent in mid-2011 to 0.36 percent in its latest estimate. The Iranian currency has also been battered. Despite some intermittent recovery, the Iranian rial has experienced around 50 percent depreciation in recent months. If not for the government's vigilance – from the imposition of capital controls and the injection of petrodollars into the economy to interest rates increases, import bans, and enforcement of strict regulations in currency markets – the Iranian currency could have experienced a larger loss.

Due to a lethal combination of Western sanctions against Iran's main ports and the expulsion of Iranian banks from the SWIFT, Iranian traders have found it increasingly difficult to access credit, conduct financial transactions, and import even basic commodities such as food, medicine, and diapers from abroad. Iran's oil exports have also taken a hit. With the exception of China, all major Asian customers such as India, Japan, South Korea, and Turkey have cut back their Iran crude imports, while switching to Iraqi, Saudi, and Emirati oil. Iran's crude exports are already the lowest in two decades, with total exports expected to decline by almost 50 percent – compared to the previous year – when the E.U. embargo kicks in. Although the increase in global oil prices has benefited Iran, the country has been forced to offer barter deals, considerable discounts, sovereign insurance, and flexible payment arrangements to keep its top customers interested. If exports continue to decline, Iran may face the stark choice of indefinitely shutting down some of its refineries.

There is no doubt that the sanctions are having an impact on the Iranian economy. However, the effect of the sanctions on Iran's nuclear policy is less straightforward. Failing to get any concession on sanctions, the Iranians have begun to backpedal on prior expressions of potential compromise on critical issues such as high-grade uranium enrichment and access to the Parchin military complex. Worryingly, if the sanctions are tightened even further without any indications of Western compromise, there is a serious possibility of the complete marginalization of moderates within the Iranian leadership, leading to a total breakdown in negotiations. Therefore, paradoxically, while the sanctions are the main reason behind Iran's return to negotiations, it is also the biggest obstacle to any diplomatic resolution of the ongoing nuclear impasse.

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