

# The Power of Petroeuros: The EU-3 vs. Iran

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In the course of the World Bank's annual conference in 2006, a spokesperson for the Board of Governors of Commerzbank, one of the largest banks in Germany, declared that his bank had no intention of limiting its activities with Iran. The Board's spokesperson explained emphatically that the suspicions regarding Iran and the nuclear question were unfounded, and that therefore the bank saw no reason to sever its commercial ties with longstanding partners. US treasury secretary Henry M. Paulson, Jr., who was the intended audience of those remarks, chose not to confront the bank's representatives during the conference itself. Instead, he dispatched his under secretary Stuart Levey to a series of visits at the bank's headquarters in Frankfurt. Some months after Levey's last visit there, Commerzbank announced the severing of most of its contacts with Iranian firms.

The case of Commerzbank illustrates the process underlying a reduction in the volume of business of European companies with Iran. Lately, EU-3 leaders tend to note with satisfaction that over the past two years there has been a sharp decline in the scope of exports from the European Union to Iran. However, they know full well that the majority of this decline in trade is not the result of their own governments' activities, but rather the result of United States pressure.

**D**uring the past two years, senior American bureaucrats have been shuttling around Europe's financial capitals in order to clarify to European banks and the large industrial corporations that their business activities in Iran are liable to cause them trouble with American financial institutions and to harm their activities in the United States. The American pressure has led more than forty banks – mostly European – to sever or limit their contacts with

Iran, and therefore the exporters and the European companies who have invested in Iran are running into problems in financing that in turn have dramatically raised the cost of doing business.<sup>1</sup> However, despite the pressure exerted by the United States on European companies and despite the negative impact that international sanctions have on the Iranian business environment, the European Union remains Iran's largest trade partner.

The National Intelligence Estimate on

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Iran's nuclear capabilities, published in December 2007, did not soften the declarations of EU-3 leaders regarding the need to intensify the economic pressure on Iran. On the contrary, over the past weeks voices have risen within the European Union calling for examining the possibility of formulating European sanctions against Iran independent of the Security Council. However, not all EU members, and certainly not all lobbies and interest groups within the various countries, are prepared to deal with the financial losses that would result from their scaling back their business relationships with Iran. According to them, sanctions derived outside of the Security Council would cause severe macroeconomic damage to the European nations without harming Iran, which would find alternatives to European goods and investments in Russia and China.

This essay analyzes the nature and extent of the economic interdependence between Iran and the European Union, in order to examine the economic and political limitations that EU-3 leaders face as they investigate ways to formulate independent sanctions against Iran. While the interdependence indeed limits the scope of EU maneuvering, the EU can nonetheless take a series of steps that will cause Iran real damage without jeopardizing the economic stability of EU nations.

### Facts and Figures

Like most Iranian economic processes, the fluctuations in Iran's business relationship with the EU are also closely related to developments on the oil market. Oil and its products represent more than 88 percent of total Iranian exports to the EU, and therefore the steady rise in oil prices over the last five years has significantly increased total European expenditures for Iranian imports. Be-

tween 2002 and 2006, there was an average annual increase of 26 percent in imports to the EU from Iran, as compared with an average annual increase of only 9 percent in total imports of the EU worldwide.<sup>2</sup>

Ostensibly, this process would have a negative impact on the EU balance of trade and affect the profitability of those European companies for whom oil represents an input in production. And yet the increase in oil prices has actually brought about increased profitability of hundreds of European companies. The rise in Iran's revenues from selling oil has allowed it to expand demand for various import goods, and the European companies that for years have had extensive business dealings with Iran and have established business infrastructures there were among the first to enjoy Iran's renewed hunger for industrial equipment, chemicals, and consumer goods. Between 2002 and 2005, there was an average annual increase of over 16 percent in the scope of exports from EU nations to Iran, while total worldwide exports from the EU rose by less than 6 percent.

However, the last quarter of 2005 began a decline in EU exports to Iran. The drop in exports together with another increase in oil prices in 2006 hurt the EU's trade balance with Iran and the total trade deficit grew by more than €2.9 billion (figure 1). This trend continued into 2007 as well: the first quarter of the year saw a drop of more than 8 percent in the scope of exports from the European Union to Iran compared with the same quarter in 2006.<sup>3</sup> While a significant portion of the

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drop in exports from the EU to Iran is a direct result of the economic pressure exerted on EU members by the United States, it also stems from Iran's orchestrated response to the international pressure. Over the last several years, Iran has striven to reduce its vulnerability to unilateral sanctions leveled by the EU and other nations, and therefore Iran

has tried to vary its trade partners and find alternatives to European goods on the markets of China and other countries.

These processes are in fact demonstrable in trade data: if only two years ago imports from the EU repre-

sented more than 41 percent of total Iranian imports, as of 2006 it stood at less than 34 percent. However, despite this decrease, the EU remains Iran's biggest trade partner, and the scope of exports from the EU to Iran is still dozens of percentage points higher than it was in 2002 (figure 2).

In other words, the sides remain greatly interdependent. Therefore, steps designed to prevent European companies from exporting to Iran will either significantly increase the cost of deals involving exports to Iran and investments there, or cause economic damages to both sides. Clearly, the macroeconomic damages that Iran will suffer as a result of these steps will be vastly greater than the damages incurred by the EU economy.

The interdependence that exists between the EU and Iran is characterized by clear asymmetry. While the EU is Iran's primary trade partner, Iran ranks only 26 on the EU's list. Exports from the EU to Iran represent less than 1 percent of total European exports, and imports from Iran to the EU represent 1.05 percent of total European imports. A

similar picture emerges when one examines separately the trade relations between Iran and each one of its large European trade partners.<sup>4</sup>

However, the aggregate data is liable to mislead regarding the EU's sensitivity. In order to understand the economic interdependence between the parties, it is not enough to examine the total scope of trade between them; it is also necessary to examine the goods the parties supply to one another, and to see if they can find alternate markets in case of a severing of relations. When attention is focused on this issue as well as other macro and micro questions, some political and economic limitations emerge, limitations that define the scope of the sanctions the EU might initiate against Iran.

### **The EU's Economic Sensitivity**

Europe's growing dependence on Iranian oil is one of the central limitations confronting EU leaders as they discuss economic sanctions against Iran. Iranian oil represents more than 3.6 percent of the EU's oil imports, and its proportion of the oil consumption basket of some important countries, such as Italy and France, is much higher than that. Clearly, blocking Iranian oil to the EU is the most painful action that can be taken against Iran, but such a move is in no way on the table because EU leaders cannot voluntarily afford to create an oil shortage, which would inevitably cause a sharp spike in prices. And while EU countries can find alternatives to Iranian oil, any announcement of replacing Iran as a supplier would shock the energy market and spark a rise in prices.

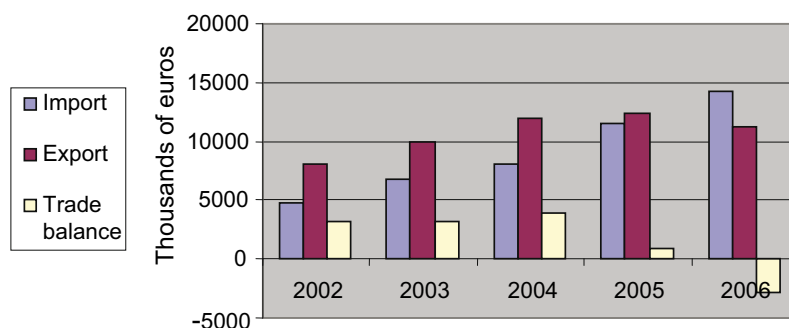
Sources within the EU have more than once expressed concern that even sanctions not aimed at Iran's oil exports are liable to cause a European oil shortage, because Iran

is liable to react by initiating an oil embargo. However, it is highly doubtful that Iran would choose such a step. Just as the EU cannot afford to renounce Iranian oil, so Iran is not interested in blocking one of its main sources of income precisely at a time when economic pressures on it are intensifying. In other words, even regarding oil the interdependence is asymmetric and favors the EU.

Nonetheless, it is clear that the EU's dependence on Iranian oil reduces its room to maneuver vis-à-vis export sanctions against Iran: EU nations are not interested in reducing oil imports from Iran, and therefore a reduction in exports to Iran will immediately increase their trade deficit. A total stop on European exports to Iran, without a decrease in imports from it, is liable to increase the EU's total trade deficit by more than 6 percent.<sup>5</sup> At the same time, this factor refers to an extreme situation in which there would be a complete and total ban on all European countries regarding any type of dealings with Iran, a step not a single European nation is suggesting at the moment.

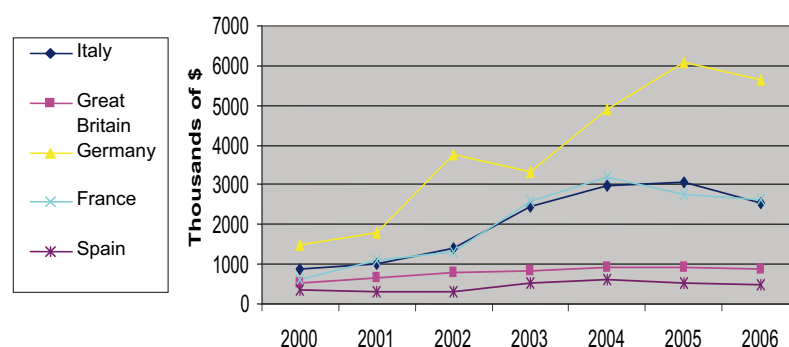
The steps that EU leaders are contemplating focus on looking for effective ways to increase business costs involved in working with Iran. One of the most effective such steps is a sweeping decision to cancel governmental export guarantees. A significant portion of European exports to Iran are backed by government guarantees that delimit the risk that commercial companies assume when they start working with such a problematic partner. Canceling the guarantees would raise the risk of doing business with Iran, and would rein in the enthusiasm of the European exporters to do so.

Over the past year, there has been a reduction in the number of guarantees issued



**Figure 1.** Trends in EU-Iran Trade

Source: European Commission: Directorate-General for External Trade (DG Trade)



**Figure 2.** Export Trends from the EU to Iran

Source: International Monetary Fund: Direction of Trade Statistic

by EU governments to companies exporting to Iran. In 2007, Germany issued export guarantees totaling €500 million, as opposed to €900 million the previous year.<sup>6</sup> However, a sudden announcement that no new guarantees will be issued is fraught with risks, because it is liable to give Iran an incentive to breach past commitments it has undertaken towards European companies. In such a case, European governments would have to stand by their word and redeem the guarantees they assumed. That is to say, a sweeping decision to do away with guarantees would decrease exports to Iran, but is liable to impose on EU governments a budgetary burden of several billion euros.<sup>7</sup>

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Rhetoric voiced by Angela Merkel and Nicolas Sarkozy in their recent visits to Washington and repeated declarations by Gordon Brown reveal that EU-3 leaders see the possibility of foiling Iran's nuclear program through diplomatic measures as a goal that is worth more than a few billion euros. In other words, the primary economic and political difficulty of imposing sanctions on Iran does not stem from a concern about a potential budgetary burden or an increased trade deficit, but from a fear of damages liable to be incurred by European businesses. Indeed, lobbyists and other interest groups are now engaged in a vigorous campaign in the corridors of European parliaments

to present a stop on exports to Iran as a catastrophe leading to the bankruptcy of hundreds of European companies and to a wave of layoffs throughout the continent. Thus, for example, a group of lobbyists representing German industrialists recently assessed that a significant reduction of exports to Iran would lead to the layoff of 10,000 German workers.<sup>8</sup>

However, it is highly doubtful that the gloomy forecasts presented by interest groups are accurate. While it is true that among the 1700 German companies doing business with Iran there are also midsize and small firms whose vulnerability to a marginal decrease in sales is high, and therefore losing the Iranian market would represent a serious setback, European business activity with Iran (when measured in financial terms) is done primarily by the large corporations, and a quick glance at their balance sheets reveals that their volume of sales to Iran is marginal

as compared to their total annual volume.<sup>9</sup> Clearly, decreasing business with Iran would force even the largest conglomerates to make changes, but it is not at all certain that most of them would be forced to reduce production lines, and they would certainly not go bankrupt.

In light of the pressure exerted by the US State Department, large corporations have tried to downsize their activities in Iran. A company such as Siemens, whose sales volume to Iran is less than 1 percent of its total annual volume, will not risk a reduction in its business with the United States (representing over 25 percent of its total volume) if American pressure increases.<sup>10</sup> That is to say, increased American pressure is a factor that to a certain extent moderates the political opposition on the part of the large European conglomerates.<sup>11</sup> In fact, even now there are meetings between the directors of the large corporations and some of the EU leaders where the sides are examining ways to decrease the volume of exports to and investments in Iran.

On the other hand, a decision to impose EU sanctions beyond those of the Security Council comes with many political difficulties. Such a decision would have to be accepted by consensus by all twenty-seven member nations, and not all EU countries are prepared to deal with the consequent economic damages and internal political struggles. Some of the mid-sized member states, such as Spain and Italy, are not at all pleased with the domination and independence assumed by EU-3 members in leading EU foreign policy.<sup>12</sup> Thus it would seem that not only struggles on the internal level but also power struggles among EU members represent a political challenge in formulating European sanctions.



The most common claim of those opposed to independent European sanctions focuses on doubting the effectiveness of sanctions. Both European conglomerates and some EU leaders are concerned that the vacuum that would be created by exiting European companies would quickly be filled by Chinese and Russian firms, and therefore any move that is formulated outside the framework of the Security Council would cause long term damage to the European concerns without harming Iran. This claim too is inaccurate.

### The Sensitivity of Iran to European Sanctions

The extent of the damage that Europe could cause Iran by reducing exports is brought into sharper relief when one divides the exports into types of goods. More than 50 percent of European exports to Iran consist of investment goods whose uninterrupted supply is critical for industrial production processes in that country. Iran's desire to reduce its dependence on Europe has not moderated the enthusiasm of Iranian industrialists to purchase from EU nations industrial equipment in which the Europeans specialize. A few months ago official Iranian sources, in a conversation with representatives of the German trade ministry, expressed their desire to buy a long list of investment goods such as power turbines, water purification systems, train engines, and other equipment that would make it possible to expand the system of transportation in the country.<sup>13</sup>

Decreasing the export of specific investment and consumer goods from Europe would obligate Iran to find alternatives in China and in other markets. However, it is not at all certain that it is possible to find suitable alternatives for the range of European goods (both China and Russia import similar



industrial equipment from Europe). Even if Iran does succeed in finding alternatives for a significant part of European investment goods, it still faces a slowdown in production processes, because Iranian industry will find it difficult to adjust quickly to a reality in which the industrial equipment with which it is familiar is no longer available.

Similar logic holds in terms of the possible effects of the reduction in direct investments and activity of European companies in Iran. It is reasonable to assume that some of the vacuum that would be created as a result of the withdrawal of European investments in Iran would be filled by firms from other countries, but it is not at all certain that these firms would be able to fill effectively the functions that the European companies have supplied to the Iranian economy. An example may be found in processes now taking place in the Iranian banking sector. Austrian and Swiss banks – institutions that do not have extensive business dealings with American institutions and therefore are not concerned with pressure from the State Department – took advantage of the large Euro-

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pean banks abandoning Iran to expand their activities there. However, these banks have not managed to supply the range of services that the large European banks formerly supplied to Iran.

Similar processes are also taking place in the industrial sector and in the oil industry. While the European industrial conglomerates and oil companies have not actually left Iran, lately the European giants, such as Sie-

mens, Shell, Total, and ENI have declared that they have no intention of competing for new tenders in Iran.<sup>14</sup> Responding to these declarations, Iran is trying to make clear to European countries that in the long

run their hesitancy may harm them, because their place is apt to be taken quickly by a long line of Russian and Chinese companies waiting for the opportunity to sign long term deals with Iran. Last December, Iran signed a \$2 billion contract with the Chinese oil company Sinopec, and signaled to European companies that it had no intention of waiting for them.<sup>15</sup>

However, many energy experts are in doubt as to the ability of non-Western companies to provide Iran all the expertise and specific input it needs in order to expand the rate of oil production in the country and to take effective advantage of the enormous oil reserves it controls.<sup>16</sup> The claim that all the Chinese and Russian energy companies are queuing up in order to enter Iran is likewise inaccurate. The return of foreign companies on investments in the Iranian energy industry – a function of the Iranian government's buyback policy<sup>17</sup> – is not attractive to many companies. Even non-Western energy companies do business with the United States

and are therefore concerned that investing in Iran is liable to hurt their dealings with the US. For example, the Russian energy company Lukoil, which is very active in the field of natural gas in the United States, announced in October that it is suspending a project it was supposed to have begun at the Anaran oil fields because of a concern that massive investing in Iran is liable to hurt its business dealings with the US.<sup>18</sup>

Should the EU countries choose to actively join the financial fight that the US Treasury Department is waging against companies that do business with Iranian firms by black-listing them, the desire of investors around the world to fill the vacuum left by the European companies would decrease. The American financial fight has caused many institutions to reduce their dealings with Iran, and it is raising the cost of doing business and the risk involved in investing in and exporting to Iran.<sup>19</sup> However, there are limits to the American financial lever, because there are multinational companies that do not do business in the United States and their dependence on Wall Street is low. A significant portion of these companies raise their capital in the financial districts of London, Paris, and Frankfurt, and therefore losing access to loans and financial tools supplied by European institutions is liable to impact negatively on their ability to function.<sup>20</sup>

An additional factor that makes European financial sanctions an effective tool is the fact that a lot of Iranian capital is deposited in European banks.<sup>21</sup> The EU has already decided to take independent financial steps and has boycotted entities that are not included in Security Council Resolutions 1737 and 1747. However, this decision is only a small step among the many that can cut Iran out of the global financial system.

The measure of autonomy of the European nations in leading financial sanctions is much higher than the measure of their autonomy in leading independent trade sanctions against any other given country (without the agreement of EU institutions). At the same time, even the most forceful voices in Europe prefer, for now, to try and act through EU institutions and avoid independent action.

## Conclusion

The European Union can advance a series of steps that would cause Iran significant damage without jeopardizing Europe's economic stability. The difficulty in initiating these steps does not stem from a concern about economic stability at the macro level, but rather from a concern about damages that might be inflicted on specific companies. Intensifying American pressure on the large conglomerates is likely to moderate the extent of political opposition that the European governments are expected to demonstrate on the matter. Similarly, a decision to intensify the financial pressure on the part of European institutions is likely to temper the phenomenon feared by many in the EU: a permanent loss of the Iranian market to other companies.

EU-3 leaders, Angela Merkel in particular, still prefer the multilateral approach and are hoping that China and Russia will join a third round of sanctions in the Security Council. Should this attempt fail, EU-3 leaders will have to take part in a complicated political struggle, both on the internal level and on the pan-European one. The outcome of this struggle will determine what the Iranian economy will look like in the coming years.

## Notes

- 1 The list of banks that have cut their ties with Iran include some financial giants, among them Deutschebank, Citigroup, HSBC, and USB.
- 2 Unless otherwise indicated, all trade data presented in this essay is taken from the International Monetary Fund, *Direction of Trade Statistics* (September 2007).
- 3 Official trade figures for the last three quarters of 2007 are not available, but reports in the financial press indicate a decline at a similar rate.
- 4 Thus, for example, total German exports to Iran – and Germany is the largest European exporter to Iran – represent less than 0.5 percent of total annual German exports.
- 5 The calculation is based on 2007 average oil prices.
- 6 "Berlin Faces Hurdles in Push to Get Business Out of Iran," Spiegel Online International, November 20, 2007. <http://www.spiegel.de/international/world/0,1518,518503,00.html>.
- 7 The primary victim of such a step would be the German government. Their rate of exposure in export guarantees to Iran is the highest among EU members. The total of German government guarantees stands at more than €5 billion.
- 8 Marcus Walter, "Germany Takes Tougher Tone," *Wall Street Journal*, December 3, 2007, [http://online.wsj.com/article/SB119663614482711060.html?mod=googlenews\\_wsj](http://online.wsj.com/article/SB119663614482711060.html?mod=googlenews_wsj).
- 9 One exception in this regard is the petrochemical company Lurgi AG whose 2006 volume of sales to Iran represented over 20 percent of its total sales.
- 10 In the past, Siemens has been on the SEC's blacklist as a company that deals with countries providing aid to terrorist organizations because of its business dealings with Iran. After negotiating with the SEC, it was removed from the blacklist.
- 11 For details on US pressure on European companies, see David Gow and Ewen MacAlice, "Washington tells EU Firms: Quit Iran Now," *The Guardian*, November 9, 2007.
- 12 For details, see for example "Iran Spurns E.U. Diplomacy Attempts," *Forbes*, March 12, 2007.



- 13 Mark Landler, "Germany's Commercial Ties with Iran Prove Hard to Cut," *New York Times*, September 21, 2007.
- 14 Steven Mufson, "Iran Adapts to Economic Pressure," *Washington Post*, October 29, 2007, <http://www.washingtonpost.com/wp-dyn/content/article/2007/10/28/AR2007102801424.html>.
- 15 Najmeh Bozorgmehr, "Iran Signals Sanction Alert by 2bn\$ Oil Deal with China Group," *Financial Times*, December 10, 2007.
- 16 Ibid; Jon Leyne, "Iran Faces Up to Tighter Sanction," BBC News, November 14, 2007.
- 17 Buyback forecasters have indicated that international companies will invest the new capital in projects for discovering new oil fields and production projects, but they cannot acquire ownership of their share of the companies. Instead the Iranian government has promised a specific portion of the total profits from the fields that were invested in.
- 18 A spokesperson for the company stated explicitly that the company is concerned about the Iranian Sanction Act, the law that allows the United States to level sanctions against companies that invest more than \$20 million a year in the Iranian oil industry.
- 19 One of the primary difficulties in exporting to Iran stems from Western banks' concern regarding opening letters of credit to Iranian banks and financial institutions on the US Treasury Department blacklist.
- 20 For details regarding financial tools that the EU can apply, see Patrick Clawson and M. Jacobson, "How Europe Can Pressure Iran," Washington Institute for Near East Policy, November 9, 2007.
- 21 Thus, for example, German banks hold Iranian capital estimated at over €6.5 billion.