

Sanctions against Iran: Not Painful Enough

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The sanctions imposed on Iran since the summer of 2012 are painful and palpable. The Iranian regime, the economic institutions, and the ordinary citizen cannot ignore the burden of the sanctions in various spheres. Nevertheless, thus far the sanctions have yet to achieve their main purpose – to alter the regime’s behavior on the nuclear question, and impel Iran to accept an arrangement that will ensure that it does not obtain nuclear weapons. It appears that the regime still hopes that its nuclear program will reach the decisive point before the sanctions do.

This article seeks to analyze the effect of the sanctions on Iran, and to assess the regime’s response to Iran’s deteriorating economic situation. The main conclusion of the analysis is that while the sanctions are having an impact on Iran’s economy, they are still not severe enough. Although there is a chance that their severity will make Iran willing to compromise on its nuclear program, the signs right now indicate a willingness to negotiate and possibly agree to a technical compromise, but without foregoing the substance of the nuclear weapons program.

If the conditions do not change, the US administration should therefore quickly and actively promote additional measures in order to intensify the pressure on the Iranian regime. One meaningful possibility for generating effective pressure on Iran is an economic blockade against it, similar to that imposed on Iraq following its invasion of Kuwait in 1990. At the same time, Iran can be offered benefits if it changes its policy. A technical analysis of the economic situation in Iran shows that while it could withstand such a blockade for quite a few years, the price would be quite high. The blockade would aggravate Iran’s economic

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problems and cause hundreds of billions of dollars in damage in just a few years, accompanied by a steep drop in the standard of living, and withstanding it would not necessarily prevent a military confrontation with the US. It is essential that the Iranian leadership comprehend the price tag if it persists in driving its nuclear weapons program forward. While economic distress could possibly generate unrest and internal pressure that could force the regime to change its policy on the nuclear issue without a blockade, to date this has not happened, and the nuclear program is progressing rapidly. It is therefore best to apply sanctions in full force in order to increase the chances of thwarting Iran's nuclear weapons program.

The Array of Sanctions Imposed on Iran

The US began imposing sanctions on Iran shortly after the Islamic Revolution. Following the takeover of the American embassy in Tehran and the seizure of hostages in November 1979, the US banned imports of oil and oil products from Iran, froze Iranian government assets in the US, and halted most exports and credit allowances to Iran. Some of these sanctions were eased in the following years, but they were tightened again after 1984, primarily in order to stop Iran's involvement in terrorism. These sanctions included a complete ban on imports of Iranian goods to the US, controls on exports of certain American goods to Iran, and an effort to block loans by international financial institutions to Iran.

The sanctions became even more stringent in the mid 1990s, with the goal of halting Iran's nuclear weapons program and military buildup. The initiative to impose most of these sanctions came from the US Congress, while the administration sought to soften them due to opposition from European governments and economic organizations. Eventually, however, the administration too came to regard sanctions as a key tool in the effort to motivate Iran to abandon its nuclear program.

The pressure exerted on Iran, as well as the American effort to impose sanctions on other countries (mainly Iraq, in 1990-2003), indicates that the aim of imposing sanctions on Iran is as follows:

- a. To exact a high economic and internal price in order to generate heavy pressure on the regime that will outweigh the benefits of obtaining nuclear weapons. From the US administration's perspective, sanctions on Iran are long term and will not be removed even if and when it obtains nuclear weapons.

- b. To harm Iran's military capability by disrupting its import of essential components in weapons development and production and by reducing the available resources for its military buildup.
- c. To create as broad-based a consensus as possible, both within the US and internationally, for exerting pressure on the Iranian regime; this consensus is also important should the US decide on a military strike against Iran. In this respect, it is important for the administration to demonstrate to the American public and the international community that it has exhausted all the non-military possibilities before turning to the military option
- d. To weaken Iran as much as possible before adopting military measures against it.

In the context of the sanctions against Iran, the Clinton administration, beginning in 1995, forbade American companies to help develop the Iranian oil sector, completely banned trade with Iran and any American exports whatsoever to Iran, and barred American institutions from providing financial services to Iran. All purchases of Iranian oil by American companies have been stopped since 1995-96, and it was also decided to impose sanctions against non-American companies investing in the Iranian energy sector.¹

The sanctions enforced against Iran during the Clinton and Bush administrations were accompanied by disputes between the American administration and European governments – not to mention disputes with Russia and China – that were in no hurry to adopt the American sanctions and sought to soften them. Nonetheless, in 2006-10 the UN Security Council imposed four sets of sanctions on Iran with the support of not only European countries, but also Russia and China. Support for these sanctions was obtained only after they were eased significantly, and the sanctions imposed therefore did not seriously inconvenience Iran. The Security Council sanctions included a ban on movement of certain Iranian individuals outside Iran, control of suspicious shipments to Iran, a ban on sales of important weapon systems to Iran, and a ban on sales to Iran of technology and materials linked to weapons of mass destruction.

For several reasons, until the summer of 2010 the sanctions had no significant effect on Iran's economic situation. First, it is extremely difficult to formulate a broad-based international consensus for applying effective sanctions, given the heavy economic and political interests of various countries in Iran. The countries objecting to the sanctions were

primarily East Asian countries – countries that depend on Iranian oil in ever-increasing quantities (most Iranian exports of crude oil are currently to East Asia). Russia also has economic and political interests in Iran. This situation significantly detracts from the ability to enforce effective sanctions. Second, Iran has been subject to strict sanctions since 1979. Over this long period, it has built a system of straw companies, forged connections with foreign companies, and created other means to bypass a large part of the sanctions. Iran found partners for violating the sanctions in countries and companies thinking about the post-sanctions period, under the assumption that the more they help Iran in its troubles, the more preference they will receive in business in the future. This is an important consideration, given Iran's key position in the energy field. Third, even in the most severe case, the sanctions do not apply to food, medicine, and humanitarian aid, since they are not supposed to put human life at risk. This loophole can be exploited on a large basis to deliver various goods to a country that is subject to sanctions.

The Change during the Obama Administration

Since the summer of 2010, and even more so since the summer of 2012, the sanctions imposed on Iran were significantly tightened under the leadership of the Obama administration.² The administration realized that the sanctions imposed on Iran until then were ineffective and had not led Iran to change its position on the nuclear issue, and understood that Iran's steady progress toward nuclear weapons capability would quickly leave the US with two difficult alternatives – a military strike against Iran, which it wished to avoid, and acceptance of a nuclear Iran. The administration was also concerned that unless it took more drastic measures against Iran, Israel would launch a military strike against Iran – a scenario it sought to avoid.

The change that took place during this period was in two aspects. First, the new sanctions imposed on Iran were much more severe than those preceding them, and they primarily targeted Iran's most sensitive points – its energy sector and the banking, financial, and trade sectors. Second, European countries, which previously objected to participation in the sanctions, began to close ranks in imposing sanctions that were almost as strict as the American sanctions.

The tightening of sanctions against Iran began in the oil sector. In July 2010, the Obama administration imposed sanctions on the sale

of fuel products to Iran and on the sale of equipment and services that would help it produce or import fuel products, such as equipment for upgrading its oil refineries. Furthermore, while until 2010 the American administrations hesitated to confront non-American companies operating in Iran, the Obama administration undertook an effort to deter international companies from continuing to do business with Iran. In November 2011, the US decided to impose sanctions on non-American companies selling equipment and services to Iran, which in effect were enabling Iran to maintain and develop its oil and gas sector and expand its production of petrochemical products. In July 2012, the administration issued an order banning the purchase of oil and oil products from Iran and transactions with the Iranian national oil company. The following month, sanctions were added against ships transporting Iranian oil and parties taking part in joint projects with Iran underway outside Iran in the energy sector.

An important step in intensifying the sanctions against Iran was the European Union (EU) decision in early 2012 to terminate the agreements for buying Iranian oil by July 2012, and to refrain from signing new agreements with Iran. Iranian sales to European countries accounted for 20-25 percent of its total oil sales, and thus this constituted a significant measure. The EU also decided to bar insurance for shipments of oil and petrochemicals from Iran; to halt trade with Iran in gold, precious metals, and diamonds; and to freeze the assets of Iran's central bank and the assets of Iranian companies linked to arms deliveries to Syria.

At the same time, the Obama administration redoubled its efforts to isolate the Iranian banking system, headed by the Iranian central bank, which is the conduit from the international banking system for Iran's oil royalties. Already in 2006, the US administration forbade American banks from handling indirect transactions with the Iranian central bank through non-Iranian banks, after the administration accused the Iranian central bank of financing Iran's WMD program and transferring funds to Hizbollah. The American effort succeeded in persuading dozens of non-American banks to stop conducting financial transactions with Iranian banks. In November 2011, the administration issued regulations imposing sanctions on

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non-American banks conducting transactions with Iran's central bank, and the bank's assets in the US were blocked in February 2012. The US administration's efforts to isolate Iran from the international banking system were reinforced by the participation of additional countries in the effort: in November 2011 the UK and Canada announced that they would no longer do business with Iranian banks, and transactions between European and Iranian banks were later banned.

The Iranian Economy: Basic Figures

Familiarity with some basic figures on the Iranian economy is necessary in order to understand the significance of the sanctions imposed on Iran. Iran has 79 million people, and is one of the world's richest countries in natural resources. Its 2011 GDP was estimated at \$990 billion in terms of purchasing power, or \$474 billion according to the official exchange rate.³ Iran's oil fields contain 151 billion barrels of oil – some 10 percent of the world's total proven oil reserves. In addition, Iran also has 17 percent of the world's gas reserves.⁴ In 2012 Iran produced an average of 4.3 million barrels of oil per day (including liquid gas). Its domestic oil consumption is estimated at 1.8 million barrels of oil per day.⁵

Iranian exports in 2011 were estimated at \$110 billion. Its primary export destinations were China – 21 percent; Japan – 9.1 percent; Turkey – 8.8 percent; India – 8.1 percent; South Korea – 8 percent, and Italy – 5.3 percent. In this context, Iranian trade with the Far East stands out. Iran's exports of goods in 2011 were estimated at \$74 billion. The main categories of its imports were machinery and spare parts for industry, food, home consumer goods, raw materials, and technical services. Iran's principal sources for its imports were the United Arab Emirates – 30.9 percent; China – 17.4 percent; South Korea – 7.1 percent; Germany – 4.8 percent; and Turkey – 4.2 percent.⁶

Iran's foreign currency balances at the end of 2011 were estimated at \$80 billion, more than a year's worth of imports, compared with \$75 billion at the end of 2010. Its external debt was estimated at \$18 billion, less than 4 percent of the GDP. Total Iranian government budget spending for 2011 was equivalent in value to \$100 billion, and its budget deficit was estimated at 2.4 percent of the GDP.⁷

Except for the high unemployment rate and inflation, the Iranian economy finished 2011 in a good state thanks to high global oil prices, which rose in part due to the tension with Iran (the price of crude "light"

Iranian oil stood at an average of \$108 a barrel).⁸ The stepped up sanctions against Iran, which began in the second half of 2012, are leaving their mark on the Iranian economy, but are still not reflected in the known macroeconomic data for its economy.

The Effect of the Sanctions on Iran

In contrast to the sanctions against Iran of previous years, the impact of the sanctions imposed in 2012 was felt strongly in various areas. First, the oil embargo by the EU and the isolation of Iran's central bank damaged Iranian oil sales. Iranian oil exports, which stood at 2.5 million barrels daily in 2011, dropped by one million or more barrels a day by the final third of 2012. Oil and oil products account for some 70 percent of the government's revenues, and therefore the decline in exports had a negative impact. While the value of Iran's exports of oil and oil products rose significantly in recent years as a result of higher oil prices, since August 2012 Iran has lost \$2.5-4 billion a month. The drop in oil exports also reflected Iran's failure to find alternative markets to replace those it lost, in part because of increased oil production by Saudi Arabia, Iraq, Kuwait, and the United Arab Emirates. It is possible that Iran may attempt to boost its oil exports by lowering prices.

Second, many international companies, including non-American, are voluntarily leaving the Iranian market and cutting their investments in Iran, mainly from the energy sector. To the extent that this trend continues, the efficiency and output of the Iranian economy will fall, because Iran will likely have to deal with companies with less expertise, meaning that it will have trouble deriving maximum production from its existing oil fields. The sanctions against the Iranian banking sector have also left a mark: Iranian banks are experiencing difficulty in providing basic services such as cash transfers, and Iranian companies are finding it difficult to pay foreign suppliers. For their part, suppliers are refusing goods and replacement parts to Iranian companies, for example, in the auto manufacturing industry, which is contributing to

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higher unemployment. As a result, Iran's difficulties are growing in both imports and exports.

Third, since early 2010, several fuel suppliers have announced that they would stop supplying fuel products to Iran. According to several estimates, sanctions have cut Iran's imports of fuel products by 75 percent since July 2010. In response, Iran has increased its internal production of fuel products and has planned to invest tens of millions of dollars in upgrading its refining capabilities, but it is unclear whether this effort will prove successful.

Fourth, the tighter sanctions against Iran caused a drop in the value of the Iranian rial in September-October 2012. Its value among money changers in the domestic market fell from 13,000 rials to the dollar in September 2011 to 28,000 in September 2012 to 40,000 rials to the dollar in October 2012. The fall in the rial's value damaged public confidence in the Iranian government's economic policy, and caused a slowdown in trade, as commercial traders are unsure how to price their goods. As a result of this steep devaluation, the public fears a drop in the value of savings, and some Iranians are buying foreign currency and gold in order to preserve the value of their savings, thereby further aggravating the situation. The Iranian government has had to impose limits on taking foreign currency out of the country, and Iranian students studying abroad are hard pressed to pay for their studies and are forced to return to Iran.

Fifth, the sanctions imposed on the Iranian banking sector, the import difficulties, and the drop in the value of the rial have brought about a substantial rise in the prices of many basic commodities in Iran. The government states that the inflation rate is 25 percent, but some believe it is much higher. In this situation, it is difficult for the Iranian government to maintain its policy of subsidies for the poorer classes, because the real value of the subsidies declines with the value of the currency, and as a result the purchasing power of many Iranians falls as well.

The Iranian Response

The deteriorating economic situation in Iran encompasses many prominent sectors. Iranian leaders have been forced to publicly admit that the sanctions are harming the Iranian economy, and have also begun to take a series of measures to curb the economic damage.

Iran regards sanctions as a key effort to not only influence its position on the nuclear issue, but also – and primarily – to destabilize the Islamic

regime, or even to overthrow it. Iran perceives the sanctions as the main element in a “soft war” that includes efforts to isolate it politically and cyber attacks. In August 2012, after the US Congress approved a series of new sanctions against Iran, Revolutionary Guards Commander Mohammad Ali Jafari asserted, “The main threat to Iran is the soft war... the Revolutionary Guards must defend the country and its citizens against the acts of hostile countries seeking to harm Iran through soft means.”⁹

Thus far the decline in Iran’s economic situation has not sparked open unrest among the Iranian public, except for a limited demonstration in Tehran in October 2012 following the drop in value of the rial that was dispersed by the police without difficulty. According to newspaper reports, however, many businessmen and citizens blame the government for the economic crisis and the fall of the rial, and some of the blame is aimed at President Ahmadinejad. The President’s critics in parliament claim that he is vacillating and acting ineffectively. The Deputy Speaker of the parliament even stated that the government had no shortage of money, and could inject it into the market for a prolonged period. Ahmadinejad himself admitted that the economic situation had worsened, but said it was due to the sanctions, aided by internal parties, and not the government’s economic policy.

It is clear to the Iranian regime that the worsening of the economic situation is liable to lead to an outbreak of internal unrest, and it therefore quickly adopted a series of counter measures. First, Iran is making an effort to expand the circle of its oil customers and find new customers in East Asia, as well as to increase its sales among its existing customers – primarily China and India. Its success thus far, however, appears limited. Iran could have found compensation for the loss in oil revenues through a global price rise, but increased production by other countries – among them Saudi Arabia, the small Gulf states, Iraq, and Libya – has thus far prevented a steep rise in oil prices, mostly because these countries, especially Saudi Arabia, are selling oil to countries that have cut their purchases from Iran, thereby preventing a price increase. Iran is also trying to bypass the restrictions imposed on it in the oil sector by flying foreign flags on Iranian oil tankers or by changing their names, but many such attempts at deceit have been disclosed. In addition, Iran is trying to work with small banks that do not do business with the US and wish to profit from the vacuum left by the US and Europe.

Second, the Iranian government is attempting to change the consumption habits of the Iranian public by announcing a “resistance economy.” Because Iranian imports have risen by double digits since 2005, the government has begun to take steps to rein in non-essential consumption, while seeking to encourage internal production rather than the import of various goods. Internal production, however, is made more difficult by the sanctions and restrictions on purchases of raw materials, which have caused the closure of factories in Iran. At the same time, the government announced that in order to save foreign currency, it would not provide foreign currency for the purchase of luxury goods such as cars and cellular telephones, and importers of these goods will have to purchase foreign currency at a much higher exchange rate.

Implications

The Iranian economy has a high degree of autonomy. This is reflected in a low ratio of imports to GDP, a relatively large agricultural sector, a low proportion of debt, high balances of foreign currency in comparison with imports, and a balanced budget. In addition, Iran finished 2011 in a good position, apart from its high unemployment and inflation rates. Despite the much stiffer sanctions in 2012, the degree of damage that they have caused Iran is much less than that generated by the economic blockade of Iraq in 1990.

These figures explain why despite the sanctions and Iran’s worsening economic situation in 2012, the Iranian regime has shown no real inclination to date to make its position on the nuclear issue more flexible. All it has done is express its willingness to renew negotiations and send signals that it would be willing to compromise on one element or another of the nuclear issue, provided that the sanctions are removed and Iran’s right to enrich uranium is recognized – meaning that it would reserve the option to continue its march toward nuclear weapons.

The Iranian leadership has presumably taken a decision in principle not to forego its nuclear ambitions, even if the economic situation becomes even worse, under the assumption that if it achieves nuclear weapons capability, the rules of the game will change in its favor. In that case, two factors could presumably change its position and make it more flexible: one, if external pressure generates sufficient internal pressure and unrest liable to jeopardize the survival of the regime. This has not occurred to date, but further deterioration in the economic situation might encourage

this scenario. The second factor is if the regime concludes that the US administration is liable to stage a military strike against Iran in the belief that even harsher sanctions would not soften the Iranian position on the nuclear question. This requires first and foremost a demonstration of determination and readiness for quick escalation on the part of the US.

Will the current array of painful sanctions achieve its goal and lead to a material change in the position of the Iranian regime? The answer to this question is as yet uncertain, but the conditions likely to prove decisive are known. They include:

- a. The severity of the sanctions: The administration is considering even more severe sanctions against Iran, but it is possible that the current level has already accomplished as much as sanctions can possibly achieve. European countries agreed to participate in the current wave of sanctions, which is an important achievement, but it is not clear whether they will agree to go further. Russia and China will probably persist in their refusal to adopt more severe sanctions.
- b. The effect of the sanctions on the Iranian economy: There is no doubt that Iran is feeling the weight of the sanctions, but the fact that they have not yet caused a real change in the Iranian position on the nuclear issue probably indicates the economy's resilience, which leaves the Iranian regime room to maneuver.
- c. Iran's determination not to surrender on the nuclear issue, even if the sanctions become more severe: As much as it is within its control, the Iranian regime is likely determined not to agree to a strategic concession on this issue. This is probably the most critical condition at stake, and the Western governments will have to consider what else can and should be done to influence Iran's determination.
- d. The possibility of an outbreak of internal unrest in Iran as a result of economic distress may well force the regime to change its position. The likelihood of this occurrence is unknown even to the regime itself, but it is aware that the potential for unrest has existed in Iran for years.

There is still some time to weigh the effect of the sanctions imposed on Iran in recent months. If, however, it emerges that the burden of the sanctions is insufficient to achieve success on the nuclear issue, it will be necessary to consider upgrading to a higher level of sanctions. In the framework of heightened external pressure led by the US, the option exists of enforcing an economic blockade of Iran, as was done in Iraq in 1990. That blockade included a naval embargo and no-fly zones over Iraqi

territory. This is a complex and difficult move, with an aspect of a war measure deviating from the realm of sanctions and “soft war,” but it is less drastic than a military strike against Iran. The advantage of a blockade, as opposed to sanctions, is that it can be physically enforced by a coalition of forces headed by the US, without the need for agreement on the part of many countries not to trade with Iran; these countries will simply be prevented from conducting such trade. There is no doubt that obtaining a UN Security Council resolution in favor of a blockade of Iran is a difficult challenge for the US, given the expected opposition by various countries, principally Russia and China.

Economic analysis indicates that a blockade would undoubtedly upset Iran’s economic situation: the GDP would shrink, the industrial sector would be severely damaged, imports would plummet, Iran would lose tens of billions of dollars a year in foreign currency revenues, the government would have to implement a double-digit percentage budget cut and cancel many projects, and the standard of living would drop precipitously. Nevertheless, technically Iran has the ability to withstand a blockade for a prolonged period, if it continues to evince determination and manages to maintain its unity and internal cohesion. In this case, it would have to implement deep cuts in the state budget and imports, so that its foreign currency reserves would be able to survive, as did Iraq under Saddam Hussein. It appears that the Iranian economy is far more resilient than the Iraqi economy was in 1990, and that Iran is less dependent on oil exports than Iraq was in 1990.

The question is not whether Iran has the ability to hold out against sanctions and even a blockade, at least until it obtains nuclear weapons capability. The question is whether the Iranian leadership, along with the population, will agree to pay such a high price in order to continue the development of nuclear weapons. True, the current economic damage is not necessarily the most important parameter likely to affect decision making in Iran; the Iranian leadership’s expectations concerning the Western countries’ determination to halt its nuclear program by any means necessary play a more important role. For this reason, a rapid escalation in measures against Iran is likely to have a greater effect than a gradual escalation. Heavy pressure on the Iranian economy does not guarantee achievement of the goal, but it would significantly improve the

chances of success, and an economic blockade is therefore likely to be an essential measure.

An economic blockade of Iran is liable to hurt the global economy. Iranian oil exports account for only 3 percent of global oil consumption, but other oil producers are currently nearing their peak production, and oil prices are highly sensitive to changes in supply. A much graver risk is a broader disruption of oil exports from the Persian Gulf, since Iran is liable to adopt military measures that will affect these exports in response to a blockade against it. Such a measure is liable to cause another steep rise in oil prices that will further detract from global economic growth.

Accepting a nuclear Iran, however, is much more dangerous to the global economy than the price incurred by severe sanctions against Iran, or even by a military strike. The Persian Gulf is home to more than half of the world's proven oil reserves, and as long as no suitable substitute has been found for oil, the world will depend on this region as a principal source of energy. Iran is known as an aggressive player in the oil market, and as such pushes for higher prices, in contrast to Saudi Arabia and the Gulf kingdoms, which believe that this strategy angers large oil consumers and expedites development of alternative energy sources, thereby in the long term harming the oil producing countries themselves. If and when Iran obtains nuclear weapons, it is liable to attempt to dictate new rules of the game in the global oil market, and it will be only a small step from there to use of the oil weapon against the free world.

Notes

- 1 Kenneth Katzman, *Iran: US Containment Policy*, Congressional Research Service, Washington, DC, August 11, 1984, pp. 8-15.
- 2 Kenneth Katzman, *Iran Sanctions*, Congressional Research Service, Washington, DC, October 15, 2012; Eskander Sadeghi-Boroujedi, *Sanctioning Iran: Implications and Consequences*, Oxford Research Group, October 9, 2012.
- 3 CIA, *World Factbook*, 2012 (CIA site: December 18, 2012).
- 4 OPEC, *Annual Statistical Bulletin*, 2012, pp. 22-23.
- 5 BP, *Statistical Review of World Energy 2012*, p. 8.
- 6 CIA, *World Factbook*, 2012.
- 7 Ibid.
- 8 OPEC *Annual Statistical Bulletin*, 2012, pp. 83.
- 9 "Soft War on Iran is Biggest Threat to Country, Gen. Mohaamad Ali Jafari Claims," *Huffington Post*, August 3, 2012, http://www.huffingtonpost.com/2012/08/03/soft-war-iran_n_1739448.html.