



## **Analyzing the Impact of European Sanctions**

**Patrick Clawson**

**Iran Primer project, United States Institute of Peace**

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### **What does the unprecedented new European Union oil embargo on Iran mean in practical terms?**

The direct impact of the new EU oil embargo is relatively limited. Economists like to say that oil is "fungible," that is, oil not sold to the EU could be sold to other countries, and so the net impact is the small cost of redirecting ship traffic and adjusting refineries to use a different mix of oil.

But the indirect impact could be much greater. In part that is because the EU will also be applying pressure on EU banks to limit or end dealings with Iran's Central Bank. Furthermore, the EU action may lead businesses, both from the EU and elsewhere, to reevaluate their presence in the Iranian market, which may be seen as becoming more problematic, that is, politically controversial and potentially subject to more and more government restrictions.

Perhaps the most important impact of the new EU oil embargo is that it signals a considerable toughening in the EU's political stance towards Iran. That could suggest that the EU would consider other economic and political measures against Iran if the nuclear impasse drags on. It would appear that the EU and the United States now largely agree on Iran policy, including the desirability of pressing Iran harder. That is quite a change from a decade ago, which is not a good development from the perspective of Iran's leaders.

### **How fast could it have an impact on Iran's economy?**

The direct impact of the EU oil embargo will take many months. Sales are permitted through June, and payment would continue for some months after that for oil shipped up through June.

But the EU oil embargo may be felt indirectly much more quickly. For one thing, many EU purchasers may scale back or end purchases well before the July 1 deadline. More importantly, Iranians may react to the EU oil embargo by anticipating that worse economic times are coming and that they should take measures to protect themselves. The Iranian currency, which is already under heavy pressure, is particularly vulnerable both because of concern about sanctions and because of Tehran's economic policies.

The EU actions come at a difficult moment for Iranian economic policy. The government has a large deficit because of the cost of the cash payments to individuals introduced when subsidies ended. Many businesses are having great difficulty paying the unsubsidized cost of fuel and electricity. To cover the government deficit and help business deal with higher costs, Tehran has apparently adopted an expansionary monetary policy, which is in turn feeding inflation. Inflation then contributes to worry that the rial is worth less, causing people to seek foreign currencies. This destructive cycle may get worse in the period before the March 21 Nowruz festival, a traditional time for major purchases.

Public perception that prices are spiraling upwards and the rial is spiraling downwards will not be welcomed by the government in the run-up to the March parliamentary elections. The risk for the authorities is that a significant part of the public blames government actions for incurring sanctions that hurt the economy. To date, the authorities try to simultaneously downplay the impact of the sanctions and to blame the foreign enemies of the Islamic Republic for the country's economic difficulties.

### **What impact is it likely to have on world oil markets and the price of oil in the United States?**

The price of oil depends in part on supply and demand, neither of which is likely to be much affected directly by the EU oil embargo. However, there may be indirect effects, for instance, if Iran reacts by closing the Strait of Hormuz or attacking shipping.

But perhaps at least as important will be the perceptions by market actors that the EU oil embargo may signal greater political tensions. Many analysts argue that world oil prices already include a "risk premium" due to concerns about potential conflict in the Gulf. That premium could rise. A contributory factor is that with world interest rates so low, the cost of holding oil stocks is not particularly high, which may make it more attractive to speculate that oil prices will go higher. Speculative or precautionary stock-building adds to demand, thereby driving prices higher in a way which confirms the speculators' expectations about future price increases. Some commentators have argued that such self-fulfilling prophecies contributed to sharp increases in oil prices in recent years.

### **How is Iran likely to react?**

Iran will search for other markets to which to sell oil. But that effort could be complicated by U.S. and EU pressure on banks around the world not to deal with the Central Bank of Iran, especially on oil sales. Several Asian purchasers of Iranian oil have recently had difficulties arranging for payment. Presumably accelerated use of blocked accounts (the purchaser pays in local currency, which Iranian customers then use to buy goods in that country for shipment to Iran) will provide one alternative for sale of much if not all of Iran's oil. Another alternative is payment in currencies other than dollars or in gold. But these workarounds could impose additional costs on Iran, reducing the value of its oil exports. Furthermore, in recent weeks, Iran has not been particularly skillful at marketing its oil, insisting on tough terms with Chinese and Indian customers who had expected discounts.

Various Iranian officials have threatened that if Iran were not able to export its oil, then Iran would attack oil shipments from other countries as they pass through the Strait of Hormuz. The Islamic Republic of Iran has periodically made similar threats, notably after the April 1980 U.S. hostage rescue attempt. But Iran has never followed through on its threats.

On the other hand, Iran did attack shipping in the Strait and the Persian Gulf between 1984 and 1988 in the so-called "tanker war" during the Iran-Iraq war. When Iran attacked shipping, it denied responsibility for doing so until caught red-handed on video by U.S. forces. In short, when Iran threatened, it did not act; when Iran acted, it denied responsibility.

There are strong reasons for Iran not to attack shipping in the Strait. Many maritime powers would object strongly to such attacks, and some might react militarily, potentially against Iran's oil shipments. But Iran has at times acted in ways that do not seem to advance its own interests, such as in the recent ransacking of the British embassy or the alleged plot to kill the Saudi ambassador to the United States. So Iran may not calculate its interests in the same way as Western commentators do.

**For more information on the EU sanctions, go to:**

<http://iranprimer.usip.org/blog/2012/jan/23/european-union-imposes-oil-sanctions-iran>

*Patrick Clawson is director of research and head of the Iran Security Initiative at The Washington Institute.*