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PolicyWatch 1877

Impact of Sanctioning Iran's Central Bank

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Brief Analysis

The debate over whether to sanction the Central Bank of Iran must consider the effectiveness of such action and the consequences for the world economy.

At their December 1 monthly meeting, European Union foreign ministers will discuss French president Nicolas Sarkozy's recent statement on Iran sanctions: "France proposes to the European Union and its member states, to the USA, to Japan, Canada, and to other countries willing to join, to take the decision to immediately freeze the assets of the Central Bank of Iran [CBI] and interrupt the purchases of Iranian oil." The EU's decision will be closely watched in Iran and across the world.

Several countries have already targeted the CBI to one degree or another. On November 21, Canada and Britain announced a ban on transactions with the CBI and other banks in the Islamic Republic, prompting Iranian calls for expelling the British ambassador and today's ransacking of the British embassy. Also on November 21, the U.S. government invoked Section 311 of the USA PATRIOT Act to warn that Iran is a jurisdiction of "primary money laundering concern," and that dealing with any Iranian bank, including the CBI, poses risks for the global financial system. In addition, Congress is considering an outright ban on transactions with the CBI. Yet the debate about whether to sanction the bank has not always been clear about the goal and potential cost of such a move.

TARGETING PAYMENTS, NOT EXPORTS

The goal of sanctioning the CBI would be to facilitate resolution of the impasse over Iran's nuclear program. Sanctions could advance that goal in two ways:

- *Frightening Iran's leaders.* If the regime becomes convinced that the West is prepared to apply whatever means necessary to halt its nuclear progress, it is more likely to suspend aspects of the program. Indeed, it already suspended some portions of the program in 2003 and again in 2004. Yet enhanced sanctions also run the risk of increasing Tehran's determination to continue research into nuclear weapons.

- *Reducing the regime's income and assets.* If Iran had less government revenue and fewer foreign exchange earnings, then its leaders might decide that the price of the nuclear impasse was too high and therefore seek a compromise. Less plausibly, reduced income could make the regime less capable of making nuclear progress -- more likely, however, the government would cut back elsewhere while preserving the nuclear program, which in any case represents only a small part of overall spending.

Sanctions on the CBI might reduce Iran's oil exports, but that would not be their goal. It is difficult to see what purpose would be served by ending such exports as distinct from ending payments to the regime. Although the former may prove necessary to achieve the latter, Washington and its allies must keep in mind that the goal is stopping the payments, not the exports.

One step short of halting the payments altogether is to decrease their size. The United States has not been very successful in the past at reducing the world market price for oil, but reducing Iran's total export revenues is more feasible. In general, sanctions on the CBI can be thought of as similar to a levy that reduces Iran's "after tax" income from oil sales. Although the United States and its industrial allies cannot directly reduce the price Iran receives for its oil sales, sanctions on transactions with the CBI would create problems for the country's oil trade that could force the regime to accept lower prices. More specifically, fewer customers would be interested in Iranian oil, and those customers would likely insist on better terms. Such sanctions would also force Tehran to use awkward and expensive means to obtain payment for oil shipments.

For its part, Tehran seems confident that further sanctions would not stop it from receiving oil payments. Iranian officials have told economists that they are prepared to conduct all foreign exchange transactions in gold if need be. This claim is probably untrue and, if implemented, would certainly be cumbersome for Iran. Yet it suggests the degree to which the regime believes it could ride out CBI sanctions. More likely, the CBI would find ways to conduct transactions with banks in friendly industrializing countries in currencies other than the dollar or euro; presumably, it would prefer to use Chinese banks and the renminbi.

From the point of view of those urging sanctions on Iranian oil, the record so far has been disappointing. The main impact has been on investment in the country's oil and gas sector; Iran has the world's fourth-largest oil reserves and second-largest natural gas reserves, but it has been blocked from developing these resources to their full potential. Nevertheless, oil production volumes continue to climb. And although net exports are decreasing because of greater domestic consumption, the killer fact -- ignored by advocates of sanctions -- is that Iran's oil revenues have steadily increased in recent years. Figures from the U.S. Department of Energy show that Iran received $73 billion in such revenues last year and is likely to net $96 billion this year -- second only to Saudi Arabia among OPEC members.

IMPACT ON GLOBAL OIL MARKETS

Sarkozy's challenge to the international community obscures a grim reality: the parlous state of the world economy and its impact on domestic politics in individual countries. In this sense, the CBI question comes down to the price and supply of oil, and how long sanctions would be imposed before they were deemed to have succeeded -- or failed.

Theoretically, any reduction in Iranian exports could be made up via the underused capacity of other oil producers, notably Saudi Arabia. But despite Riyadh's suspicion of Iran, the kingdom would likely hesitate at being perceived as a leader in any such confrontation. Saudi oil policy is often seen as doing what is necessary to keep oil markets orderly, but this tendency cannot be viewed in isolation. Riyadh regards U.S. policy toward this year's uprisings in the Middle East as wrong-headed, and Saudis are not deaf to the implied hostility of longstanding calls to eliminate U.S. dependence on foreign oil.

Meanwhile, the overall price of oil this year is higher than in 2008, with the annual average exceeding $100 per barrel for the first time. In real terms, the average price is the highest in 147 years. This spike reflects strong demand in emerging market economies and tight supply caused by disruptions of Libyan and Syrian crude. For the many countries that import oil, the extra costs have heightened fears of a renewed slump. Politicians also worry that further sanctions on Iran, never mind political or military action, would spur a sudden hike in oil prices. Although such a development could be ameliorated by the release of emergency stocks, this is a tricky mechanism requiring levels of international agreement only attainable by careful diplomatic preparation or imminent catastrophe.

In all likelihood, the most immediate challenge will be persuading major importers of Iranian oil to find other sources or tolerate payment difficulties. Last year, China, Japan, India, Italy, and South Korea accounted for 72 percent of Iran's oil exports.

Other issues include how Iran might react to sanctions aimed at its oil exports. In the past, the regime has implied that if it cannot export oil, then other Persian Gulf countries will not either. Although this has been seen in terms of countering a military blockade, draconian sanctions could also prompt an Iranian military response or support for subversion, which would need to be countered. Around 40 percent of internationally traded oil passes daily through the strategic Strait of Hormuz.

The biggest questions, though, are how effective increased sanctions would be, and how quickly they would spur Iran to alter its nuclear policy and enter meaningful negotiations. So far, the debate in Washington has concentrated on politics rather than these policy issues.

Patrick Clawson is director of research at The Washington Institute. Simon Henderson is the Baker fellow and director of the Gulf and Energy Policy Program at the Institute. ❖

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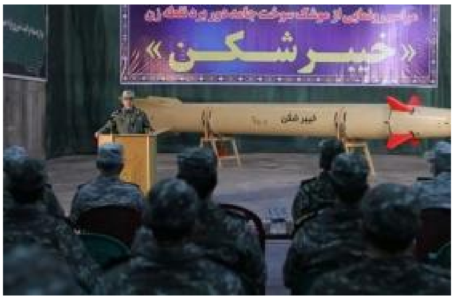

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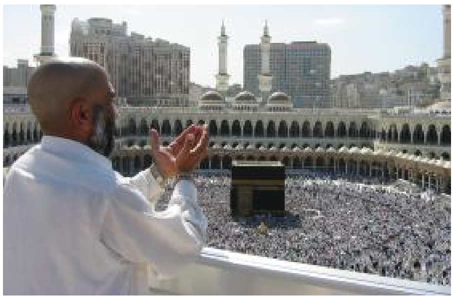

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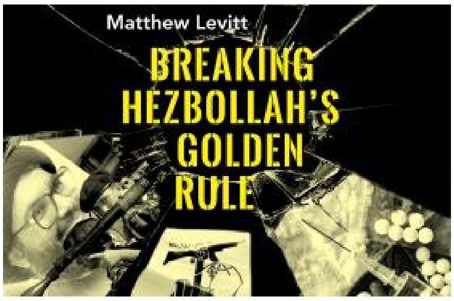

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