Pulling Tehran's Purse Stings:

Leveraging Sanctions and Market Forces to Alter Iranian Behavior

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Articles & Testimony

On March 15, 2007, Institute senior fellow and director of the Stein Program on Terrorism, Intelligence, and Policy, testified before a joint hearing of the House of Representatives Committee on Foreign Affairs Subcommittee on Terrorism, Nonproliferation and Trade and Subcommittee on the Middle East and Central Asia. The following is the prepared text of his testimony.

How can the United States and the international community raise the costs for Iran's continued defiance of the international community over suspension of its uranium enrichment program? What levers are likely to feed on domestic discontent and induce the regime in Tehran to abandon such objectionable and threatening activities as its sponsorship of terrorism, production and proliferation of weapons of mass destruction (and the missile systems to deploy these weapons)?

Most commentators agree that any viable answer has to include a combination of military, diplomatic and financial tools as well as a mix of carrots and sticks. Where experts differ is on the question of how to apply these tools and in what combinations.

Keeping the military option on the table is important, but is by no means an attractive option. First, there is no simple military option that could wipe out Iran's nuclear program. Second, Iran today is one of the few places in the greater Middle East where the regime is anti-American but the people are not. Invading Iran would draw on Iranian nationalism and unite the population against the United States.

As for diplomacy, sitting at the table with Iranian officials in the context of improving the security situation in Iraq was a good thing. There is, however, ample reason to doubt the sincerity of Iran's diplomatic message not only on Iraq, but on the nuclear issue and terrorism as well. While maintaining both military and diplomatic options -- with the former as a measure of last resort and the latter as the preferred tool of choice -- the United States should continue to apply targeted financial measures against Iran. These include not only graduated sanctions but also efforts to leverage existing market forces. Together, these targeted financial measures offer the most flexible, regime-hostile-people-friendly, realistic tool at our disposal.

Graduated Sanctions

Graduated sanctions, including multilateral UN sanctions and unilateral measures to protect the U.S. financial system, are critical and effective tools. Employing these in a graduated manner demonstrates that the purpose of such measures is not simply to punish Iran but to encourage a change in the regime's behavior. Indeed, targeted financial measures are aimed at illicit conduct not at a specific country.

UN Security Council Resolution 1737 appropriately initiated sanctions against a list of individuals and entities involved in Iranian proliferation activity and called for additional sanctions if Iran continued to defy the international community over its enrichment program. It is critical that the international community both enforce the existing sanction regime and quickly agree on and implement a second tier of sanctions. Both should include a focus on key Iranian leadership figures and the Islamic Revolutionary Guard Corps (IRGC).

The annex to UNSCR 1737 listing entities involved in Iranian proliferation activity does not include the IRGC. But two key leaders, IRGC commander Maj. Gen. Yahya Rahim Safavi and IRGC air force chief Gen. Hosein Salimi, are listed as persons involved in Iran's nuclear and/or ballistic-missile programs. Under the resolution, member states "shall freeze the funds or other financial assets and economic resources . . . that are owned or controlled by the persons or entities designated in the Annex." In other words, by virtue of listing the overall head of the IRGC (and the head of its air force), the UN empowered -- a strict reading suggests it requires -- member states to freeze IRGC funds and financial assets. Since some of our foreign partners interpret UNSCR 1737 differently, the IRGC should be explicitly included in the second round of sanctions now being negotiated.

To be sure, the IRGC is precisely the element within Iran that should be targeted. Considered the backbone of President Mahmoud Ahmadinezhad's political power base, the IRGC is an elite military corps that operates independently of Iran's regular armed forces and reports directly to the supreme leader. The IRGC is deeply involved in the country's nuclear, missile and other weapons proliferation activities, and maintains a special branch -- the Quds Force -- responsible for providing funds, weapons, improvised-explosive-device technology and training to terrorist groups like Hizballah and Hamas and insurgents attacking coalition and Iraqi forces in Iraq. Indeed, U.S. officials recently revealed that Quds Force commander Mohsin Chizari was among the six Iranians detained in northern Iraq last month.

Applying targeted financial measures against the IRGC represents the kind of regime-hostile, people-friendly sanction that punishes those engaged in offensive behavior without harming the average Iranian citizen. Indeed, the award of no-bid contracts to IRGC companies is already the stuff of domestic criticism and charges of cronyism. Moreover, the IRGC controls vast financial assets and economic resources. While most of the actual funds and assets are in Iran and beyond seizure, the IRGC's business and industrial activities -- especially those connected to the oil and gas industries -- are heavily dependent on the international financial system. Consider, for example, the $2.09 billion contract to develop parts of the South Pars natural gas field, or the $1.3 billion contract to build parts of a pipeline, both meted out to the IRGC's engineering arm, the Khatam-ol-Anbia.

Other international measures that should be included in the next round of sanctions include an embargo on the sale of arms to Iran, asset freezes and travel restrictions on senior Iranian officials tied to the regime's procurement activities and support for terrorist groups, and cutting off government-sanctioned import-export credits to Iran. Additional measures could focus on the shipping and shipping insurance industries, without which Iran can neither export its crude oil (which is the backbone of the Iranian economy) nor import refined oil (which is heavily subsidized by the government). One thing that should not be tolerated is the introduction of a false distinction between financial measures and trade, which some European partners propose in an effort to maintain business contracts with Iran while imposing other financial sanctions.

Domestically, the Treasury Department should continue to take action to safeguard the U.S. financial system from abuse by targeting Iranian financial institutions knowingly facilitating financial transactions in support of terrorism or proliferation activities. Treasury's domestic actions have also been graduated. In September 2006, the Treasury Department cut off Bank Saderat from the U.S. financial system by denying it the ability carry out U-turn dollar transactions through third party banks. Bank Saderat was cited for facilitating Iran's transfer of millions of dollars to Hizballah and other terrorist organizations each year. Four months later, in January 2007, the Treasury Department went a step further, fully designating Bank Sepah, its wholly-owned British subsidiary, and its chairman. Bank Sepah served as "the financial linchpin" of Iran's missile procurement network.

Leveraging Market Forces

The effectiveness of sanctions is increased manifold when they are multilateral. That said, the impact of unilateral U.S. sanctions is also felt internationally due to existing market forces. Foreign financial institutions and private industry, for example, increasingly incorporate the Treasury Department's designation lists into their due diligence databases not because they are required to do so but out of their own fiduciary interests. While in the business of making a profit, they have a responsibility to their shareholders to balance profit margin and risk, as well as gaggles of cautious lawyers looking over their shoulders to safeguard these firms from reputational risk.

There exists today one global economy, one international financial system -- and the United States is at its center. Financial institutions are eager to maintain branches in New York City, which provides the Treasury Department significant leverage over their activities worldwide. U.S. officials have therefore met with much success discussing global risk with governments and the private sector alike. Whether referring to government sponsored import-export insurance, lines of credit provided by public or private banks, maintaining correspondent banking relationships with Iranian banks or even facilitating their transactions (in dollars or other denominations) -- the common question all parties doing business with Iran must ask themselves is, "Do you really want to be doing business with high risk actors like Iran?"

To be sure, there is near unanimous agreement that Iran's pursuit of a nuclear weapon and its support for terrorism poses significant risks to global security. But there are more specific economic reasons for avoiding business with Iran as a country with a heightened risk for investment.

Consider a few examples:

• Iran engages in a variety of deceptive financial practices to deliberately conceal the nature of its illicit business. Bank Sepah, for example, requested that other financial institutions remove its name from transactions when processing these transactions in the international financial system. Similarly, Hizballah's Jihad al-Bina construction company, designated by the Treasury Department last month, approached solicitation targets in the name of proxies to disguise its ties to Hizballah and Iran.

• According to the State Department's recently released International Narcotics Control Strategy Report, "there are currently no meaningful anti-money laundering (AML) controls on the Iranian banking system." Moreover, according to the report, Iran claims to have established a financial intelligence unit (FIU) but has provided no documentation or details on its existence.

• In light of these deceptive practices and lack of AML controls, how can financial institutions or multinational corporations have any level of comfort that their funds do not end up in Iran's nine-digit budget line item for support to terrorist groups or in its clandestine efforts to procure materials for its WMD programs through front and shell companies?

When the public sector shares information with the private sector and informs banks and business of these risks, market forces lead many to forgo business with Iranian institutions. In light of all of the above, it should not surprise that the OECD raised the risk rating for Iran in early 2006. And, in the event banks and corporations do not determine that the reputational and litigation risks outweigh the potential profit benefits, the fact that these institutions want to conduct business in the United States often leads them to conclude that putting their U.S. business at risk is not worth the investment in Iran.

Undersecretary of the Treasury Stuart Levey put it best in a recent speech he gave in Dubai to the Fifth Annual Conference on Trade, Treasury and Cash Management in the Middle East:

"It is clear that many businesses are taking it upon themselves to scale back [on business with Iran]. At first glance, this may appear to present a tempting business opportunity for other corporations to step in. However, there is a reason that these other companies are pulling back: they have decided that the risks of business with Iran outweigh any potential gain."

Later in his speech, the undersecretary was more direct: "Those who are tempted to deal with targeted high risk actors are put on notice: if they continue this relationship, they may be next."

Conclusion

Targeted financial measures represent the strongest non-military tool at our disposal to convince Tehran that it can no longer afford to engage in dangerous, destabilizing activities like proliferation and support for terrorism. A combination of graduated sanctions and leveraged market forces can compel Iran to reconsider the utility of pursuing such endeavors.

Already there are signs of domestic discontent within Iran, and targeted financial measures can produce further political pressure within Iran. According to the Economist Intelligence Unit, the nuclear crisis (and subsequent sanctions) "is imposing a heavy opportunity cost on Iran's economic development, slowing down investment in the oil, gas and petrochemical sectors, as well as in critical infrastructure projects, including electricity." This assessment stands in stark contrast to the findings of a 2003 World Bank report on Iran, which noted the "daunting unemployment challenge" facing Iran and concluded: "Unless the country moves quickly to a faster path of growth with employment, discontent and disenchantment could threaten its economic, social and political system."

We are already seeing the benefits of this strategy. Banks like UBS, HSBC, Standard Chartered, Commerzbank, and others have decided to cut off or curtail dealings with Iran. Some foreign banks are refusing to issue new letters of credit to Iranian businesses, and Iran now faces a standoff with Russia over Tehran's apparent desire to pay for Bushehr in euros, not dollars.

Targeted financial measures are not symbolic sanctions. They have teeth, and Tehran is wary of their bite. ❖

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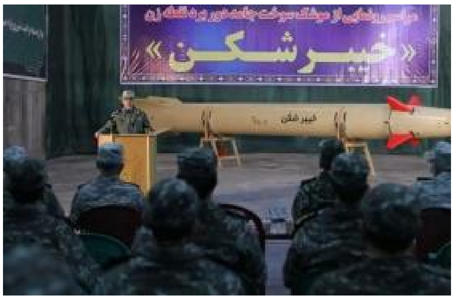

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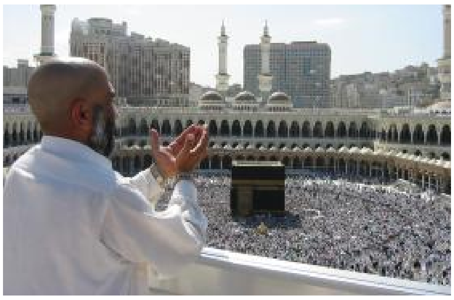

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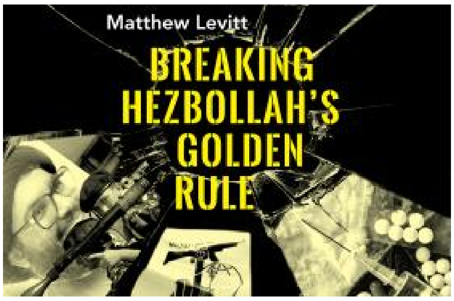

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