IDC HERZLIYA
Lauder School of Government, Diplomacy & Strategy
IPS Institute for Policy and Strategy
כנס הרצליה
HERZLIYA CONFERENCE

כנס הרצליה
השנתי העשירי
על מאזן החוסן והביטחון הלאומי
HERZLIYA 2010 הרצליה
The Tenth Annual
Herzliya Conference

Working Paper

February 31 - January 3, 2010

The Economic Impact of Stricter U.S. and U.N. Sanctions: Focus on the Iranian Revolutionary Guard Corps

A Working Paper in Preparation for the Herzliya Conference 2010

Itzhak Gal

Yair Minzili

INTERDISCIPLINARY CENTER HERZLIYA
LAUDER SCHOOL OF GOVERNMENT, DIPLOMACY AND STRATEGY
INSTITUTE FOR POLICY AND STRATEGY

2 0 1 0

The Economic Impact of Stricter U.S. and U.N. Sanctions: Focus on the Iranian Revolutionary Guard Corps

Written by: Itzhak Gal and Yair Minzili

A Working Paper in Preparation for the Herzliya Conference 2010

This paper reflects the opinion of its authors only

Executive Summary

Although Iran is a major oil exporter its government is relatively vulnerable to well-targeted economic sanctions.

Iran is already subject to a wide range of U.S. sanctions that restrict trading with it and limits U.S.'s investment and foreign aid. There are also specific sanctions on the Revolutionary Guard.

Several U.S. laws and Executive Orders extend sanctions also to foreign companies that do business with Iran, as part of an effort to persuade foreign firms to choose between the Iranian market and the much larger U.S. market.

International sanctions include three U.N. Security Council resolutions—1737, 1747, and 1803 (2006 – 2008) that imposed sanctions primarily on Iran's weapons of mass destruction (WMD) infrastructure.

The continued international pressure on Iran has hurt Iran's efforts to increase its oil production, and has reduced foreign investment, particularly by Western countries. International companies are increasingly reluctant to do business with Iran, considering the high risk associated with such business; and some large European banks have curtailed business with Iranian bodies that are sanctioned.

However, though the present U.S. and U.N. sanctions are targeted at the economic weaknesses of the Iranian Regime, these sanctions clearly fall short of crippling the economy or the economic position of the Regime to a degree that would make the Iranian government change its policies.

Following the expiry of President Obama's December 31st deadline, the U.S. Administration is considering new sanctions against Iran. In a bid to exploit political tensions inside Iran, and considering the enhanced pivotal position of the Revolutionary Guard in the post June Presidential Election Era, the Obama Administration is expected to target the new wave of sanctions mainly on the Revolutionary Guard.

Though the Revolutionary Guard has become a much "larger target", we suspect such sanctions – aimed solely at the Revolutionary Guard and its front companies – might not be powerful enough to make the Iranian Regime stop its nuclear program. However, the "menu" of other available sanctions under discussion (detailed and explained below) provides the U.S. Administration with an effective and powerful arsenal of sanctions, which it can use; perhaps in stages, under an escalating program.

Iranian Vulnerability to Economic Sanctions

Though Iran is a major oil exporter, the Iranian government is relatively vulnerable to well-targeted economic sanctions. Oil and gas exports that are Iran's main export revenues constitute about 80% of the total exports, the government's chief source of foreign exchange, and the most important source of revenue in the State Budget. The government's dependency on oil income makes it vulnerable even to partial decline in oil exports. Moreover, as shown in the Annex, more than two thirds of Iranian oil is exported to close allies of the U.S., which would render sanctions in this regard easier to apply.

Iran's economy is still dominated by the state, which is the recipient of revenues from crude oil exports, and quasi-state actors. The Islamic Revolutionary Guard Corps (Revolutionary Guard, *Pasdaran* in Persian) is the most powerful among these quasi-state actors, and its role in the economy has become even more dominant since the June 2009 Presidential Elections, along with its pivotal new position in Iranian politics (see details below). This entails that stricter economic sanctions against the Revolutionary Guard would be quite painful for the Iranian Regime.

Iran is highly dependent on imports of gasoline and of certain other hydrocarbon products, which are necessary to meet its domestic consumption demands. This vulnerability was highlighted in December 2007, when Turkmenistan halted natural gas supplies to Iran due to a pricing dispute. Millions of Iranians suffered of the bitter cold when shortage of gasoline for heating grew.

The Iranian petroleum sector is plagued with aging infrastructure and old technology. Iran needs large international investments in order to maintain its present oil production and export, and to develop its refining capacity.

The Revolutionary Guard and its Economic Role [1]

The Revolutionary Guard was founded as an ideological guard for the revolutionary regime. Today, however, it has evolved into an expansive sociopolitical-economic conglomerate whose influence extends into virtually every aspect of Iranian political social and economic life.

The Revolutionary Guard controls the Basij volunteer militia that enforces adherence to Islamic customs, and has been the main instrument to repress recent post-election protests in Iran. In addition to its pivotal role in the political realm, the Revolutionary Guard oversees a robust apparatus of media resources, education programs, homeland defense, and more.

In the economic sphere, the Revolutionary Guard controls strategic industries and commercial services ranging from dam and pipeline construction to automobile manufacturing, along with illicit smuggling and black market enterprises; and its influence has been extended into virtually every sector of the Iranian market.

The Revolutionary Guard's economic activity is conducted through a network of businesses it has established. In 2007 the Revolutionary Guard controlled over one hundred companies with roughly $12 billion in construction and engineering capital.

Its affiliate Ghorb (also called Khatem ol-Anbiya, Persian Phrase for "Seal of the Prophet") is said to have won 750 oil & gas contracts and construction contracts over the last five years. The Revolutionary Guard has its own civilian port facilities, its affiliate Bahman Group manufactures cars for Mazda; and in September 2009 it bought a 50% stake in Iran Telecommunication Company (at a reported cost of some $8 billion). The Revolutionary Guard also serves as a leading investment channel for many of Iran's leaders.

The control of the Revolutionary Guard over Iran's economy has recently been demonstrated by its decision to use US$ 1 Billion of the state "Oil Reserve Fund" for the financing of one of the Gas Projects of its Anbiya affiliates, as per specific authorization by the President.[2]

Present status of U.S. sanctions on Iran [3]

Iran is subject to a wide range of U.S. sanctions that restrict trade with Iran, investments in it, and giving U.S. foreign aid to it that requires the United States to vote against international lending to Iran.

Several laws and Executive Orders extend sanctions also to foreign companies that do business with Iran, as part of the effort to persuade foreign firms to choose between the Iranian market and the much larger U.S. market. In addition, there has been movement on the part of some U.S. states to sever their relations with firms that do business with Iran, even if such trade is legal.

The Obama Administration has not altered any U.S. sanctions on Iran—and in fact only renewed the U.S. trade and investment ban on Iran (Executive Order 12959) in March 2009.

[1] Based on Frederic Wehrey, The Rise of the Pasdaran; Kenneth Katzman, Iran: U.S. Concerns and Policy Responses; Shayerah Ilias, Iran's Economy; ISN Security Watch, IRAN'S REVOLUTIONARY GUARDS

[2] IPS January 4, 2010

[3] Kenneth Katzman, *Iran Sanctions* (July 9, 2009 & December 9, 2009); Kenneth Katzman, Iran: *U.S. Concerns and Policy Responses* (December 7, 2009)

Sanctions on investment in the Iranian energy sector

U.S. officials have identified Iran's energy sector as a key Iranian weakness. The U.S. effort to curb international energy investment in Iran began in 1996 with the Iran Sanctions Act (ISA).

ISA consists of a number of "triggers"- activities which, if carried out, would be taken to be violations of ISA and cause the firm or entity to be sanctioned in accordance with ISA's provisions.

However, the European Union opposed ISA on the grounds that it was an extraterritorial application of U.S. law. The U.S. decided to avoid a trade confrontation, and in 1998 the Clinton Administration waived ISA sanctions on the first project that was deemed a violation. Later on, by the end of the 1990s, the Administration indicated that future investments by EU firms in Iran would not be sanctioned. According to a recent report to the U.S. Congress, no firms have been sanctioned under this specific act.

Treasury Department "Targeted Financial Measures"

Various "targeted financial measures" have been undertaken by the U.S. Treasury Department, particularly since 2006. Strengthened by leverage provided by U.N. Security Council resolutions, U.S. officials have been able to convince numerous foreign banks that are dealing with Iran that these dealings entail financial risk and foster proliferation of terrorism. These actions have partly dried up financing for the energy industry and other projects in Iran, and have caused potential investors in the energy sector to withdraw from or hesitate about finalizing pending projects.

Treasury and State Departments officials, gave on April 17, 2008 testimony before the House Foreign Affairs Committee, in which they said they had persuaded at least 40 banks not to provide financing for exports to Iran or to process dollar transactions for Iranian banks. Among those that have pulled out of Iran are UBS and Credit Suisse (Switzerland), HSBC (Britain), Germany's Commerzbank A.G. and Deutsche Bank A.G. Some of these results were achieved due to U.S. pressure. In 2004, for example, the Treasury Department fined UBS $100 million for the unauthorized movement of U.S. dollars to Iran; and just recently Credit Swiss Bank was subject to a U.S. $ 500 Million fine.

In action intended to cut Iran off from the U.S. banking system, the Treasury Department barred U.S. banks from handling any indirect transactions with Iranian banks (on November 2008). Thus far, the Treasury has not imposed any specific sanctions against Bank Markazi (Central Bank), reportedly due to European opposition.

Sanctions on the Revolutionary Guard

On October 21, 2007, the Treasury Department designated the Revolutionary Guard as a whole and its companies as proliferation entities subject to sanctions under Executive Order 13382, along with the Iranian Ministry of Defense, and several Revolutionary Guard commanders. Simultaneously, the Qods Force of the Revolutionary Guard was named a terrorism supporting entity under Executive Order 13224. Both orders freeze U.S.-based assets and prevent U.S. transactions with the named entities.

Present status and of U.N. sanctions on Iran [4]

Three U.N. Security Council resolutions—1737, 1747, and 1803 (2006 – 2008) imposed sanctions primarily on Iran's infrastructure of weapons of mass destruction (WMD). The following is a summary of the provisions of U.N. Resolutions on Iran Nuclear Program (1737, 1747, and 1803):

- Require Iran to suspend all uranium enrichment and its related activities, and the construction of the 40-megawatt heavy water reactor at Arak.
- Prohibit transfer to Iran of nuclear, missile, and dual use items to Iran, except for use in light-water reactors.
- Prohibit Iran's exporting of arms or WMD-useful technology.
- Freeze the assets of 40 named Iranian persons and entities, including Bank Sepah.

[4] Based mainly on Kenneth Katzman, *Iran: U.S. Concerns and Policy Responses*

- Require that countries exercise restraint with respect to travel of 35 named Iranians and ban the travel of 5 others.
- Call on states not to export arms to Iran or support new business with Iran.
- Call for "vigilance" (a non-binding call to cut off business) with respect to all Iranian banks, particularly Bank Melli and Bank Saderat.
- Call on countries to inspect cargoes carried by Iran Air Cargo and Islamic Republic of Iran Shipping Lines and be aware of indications that they carry cargo banned for carriage to Iran.

The impact of U.S. and U.N. sanctions

International pressure on Iran to curb its nuclear program has increased the hesitation of many major foreign firms to invest in Iran's energy sector, hindering Iran's efforts to expand oil production beyond 4.1 million barrels per day.

International sanctions have reduced foreign investment to some extent, particularly by Western countries. Since 2006, European Union countries, including France, Germany, and Britain, have curtailed export credits to companies doing business in Iran. For example, in 2007, German export credits backing trade with Iran totaled about $730 million; about half the value of German export credits in 2006 and one-fifth that in 2004. Germany does not actively dissuade companies from doing business in Iran, but it is conducting extra scrutiny of export authorizations requests and evaluates the financial risks of doing business with Iran more closely. Some large European banks have reduced businesses with sanctioned Iranian bodies. However, Iran appears to be successfully negotiating deals with some Asian countries, but even there successful completion of new agreements has been slow.

European Sanctions

As mentioned above, the U.S. effort to mobilize Western European entities to sanctions has been notable especially in the financial and credit sector. This was designed to have an effect on Iran's ability to pursue commercial activities with the assistance of leading banking firms. Large Western European banking institutions to join the U.S. led effort in this realm include those in Switzerland, namely UBS and Credit Suisse, in the United Kingdom, namely HSBC, Germany, namely Commerzbank and Deutsche Bank, and France, namely BNP Paribas. However, a recent article in the London Financial Times (of January 27, 2010), emanating from Hong Kong, quotes Iranian officials as stating that these sanctions are being easily circumvented by Iran by the use of smaller banks and of banks located in other countries, including Hong Kong.

Other than in the financial sphere, the European governments, notably in France and Germany, have put pressure on commercial companies to reduce the scope of their trade with Iran. In France, pressure by the Sarkozy government yielded the suspension by Total of significant envisioned investment in the expansion of Iran's energy sector. The scope of Germany's commerce with Iran has been somewhat reduced too, and recently it was announced that a German company is withdrawing from its participation in the upgrading of Bandar Abbas harbor. Additionally, Siemens has announced that it will withdraw from activities in Iran. The pressure on European companies apparently comes from two quarters: one is the respective governments, the other, perhaps significant too, is the result of U.S. legislation that would prohibit or restrict the activities of these companies in the much more lucrative U.S. market, so that for those companies the decision to drop their Iran activities becomes an obvious choice.

New Sanctions on Iran and Specifically on the Revolutionary Guard

Though present U.S. and U.N. sanctions have hurt the Iranian economy, and are targeted at the weaknesses of the Iranian Regime, these sanctions clearly fall short of crippling the economy or the economic position of the government to a degree that would make the Iranian government change its policies.

Following the expiry of President Obama's December 31 deadline, the U.S. Administration is considering new sanctions against Iran. According to articles in the Washington Post and other leading U.S. newspapers, the measures would probably be imposed in three ways - at the U.N. Security Council (to the degree attainable in light of Chinese and Russian positions), in conjunction with U.S. closer (European) allies, and unilaterally by the U.S.- more or less simultaneously.

Since the U.S. does not trade significantly with Iran now, all these moves will aim primarily at reduction of trade of other countries with Iran, and forcing international banks and companies to reduce or stop their business with Iran in general, or with certain Iranian entities.

In a bid to exploit political tensions inside Iran, and considering the enhanced pivotal position of the Revolutionary Guard in the post June Presidential Election Era, the Obama Administration is expected to focus the new wave of sanctions mainly on the Revolutionary Guard.

However, although the Revolutionary Guard has become a much "larger target", many suspect that such sanctions – aimed solely at the Revolutionary Guard and its front companies – would not be powerful enough to make the Iranian Regime stop its nuclear program.

Taking this possibility into consideration, we may expect the U.S. Administration and Congress to move on with preparations for more assertive steps.

In fact, the U.S. Congress has already passed several bills and provisions, and is debating several more, which would enable the Obama Administration enforce much more powerful sanctions on Iran in case sanctions on the Revolutionary Guard would not do the work with the Iranian Regime.

Most of these bills seek to take advantage of Iran's dependence on imported gasoline. Such sales to Iran (by foreign firms) cannot be at present sanctioned under ISA (Iran Sanction Act). These suggested moves include:

- Adding the sale of refined gasoline to Iran to the list of ISA (Iran Sanction Act) violations;
- Expanding the list of forbidden activities under the ISA to include: the enhancement or maintenance of Iran's oil refineries; providing shipping insurance or other services concerning delivery of gasoline to Iran, supplying equipment to oil refineries or constructing them.
- Expansion of the menu of available U.S. sanctions under the ISA against violators to include: (1) prohibiting transactions in foreign exchange by the sanctioned firm; (2) prohibiting any financial transactions on behalf of the sanctioned firm; (3) prohibiting any acquisitions or ownership of U.S. property by the sanctioned body; (4) requirement that no Executive agency of the U.S. government contract with firms that cannot certify that they are not supplying gasoline or refinery equipment to Iran.

Other bills and suggestions include:

- Sanctions on Iran's Central Bank, which would severely limit Iran's external trade;
- An outright embargo on refined petroleum exports to Iran;
- Applying the U.S. trade ban to subsidiaries of U.S. firms (if those subsidiaries were used by the parent firm specifically to conduct trade with Iran).

The following sanctions were mentioned as a possible menu that the U.S. may put for the consideration of major U.S. allies in and outside Europe:

- Prohibiting travel by Iranian officials;
- Banning international flights to and from Iran;
- A ban on exports to Iran of refined oil products or of other products;
- Financial and trade sanctions, such as a freeze on Iran's financial assets abroad;
- Limiting lending to Iran by banks or international financial institutions;
- Banning worldwide investment in Iran's energy sector;

- Banning insurance for Iranian shipping;
- Imposing a worldwide ban on sales of arms to Iran;
- Imposing an international ban on purchases of Iranian oil or any other trade.

In summary, the set of available sanctions under discussion as detailed above provides the U.S. Administration with an effective and powerful arsenal of possible sanctions, which it can use. These sanctions may be implemented in stages, under an escalating program.

Sources:

1. Kenneth Katzman, *Iran Sanctions* (Washington D.C., Congressional Research Service), www.crs.gov (RS20871, July 9, 2009 & December 9, 2009);
2. Kenneth Katzman, *Iran: U.S. Concerns and Policy Responses* (Washington D.C., Congressional Research Service), www.crs.gov (RL32048, December 7, 2009);
3. Frederic Wehrey et al. *The Rise of the Pasdaran*, Rand Corporation, 2009;
4. Shayerah Ilias, *Iran's Economy*, (Washington D.C., Congressional Research Service, June 12, 2008);
5. Greg Bruno, ISN Security Watch, *Iran's Revolutionary Guards* (June 2009);
6. IPS , January 4, 2010.

Annex: Iran - Selected Economic Indicators

Economic Growth - 6.4% (2008 est.).

Per Capita Income - $13,100/yr purchasing power parity.

GDP - $ 842 billion purchasing power parity (2008).

Oil Production/Exports - 4.0 million barrels per day (mbd) / 2.4 mbd exports. Exports could shrink to zero by 2015-2020 due to accelerating domestic consumption.

Major Oil/Gas Customers:

- China—300,000 barrels per day (bpd); about 4% of China's oil imports.
- Japan—600,000 bpd, about 12% of oil imports.
- Other Asia (mainly South Korea)—450,000 bpd.
- Italy—300,000 bpd.
- France—210,000 bpd.
- Netherlands 40,000 bpd.
- Other Europe—200,000 bpd.
- India—150,000 bpd (10% of its oil imports).
- Africa—200,000 bpd.
- Turkey—gas: 8.6 billion cubic meters/yr.

Refined Gasoline Import/ Suppliers:

Imports that were $5 billion per year in 2006, are now, after rationing, about $4 billion per year.

Traders and suppliers include:

- Vitol (Switzerland), which supplies about 30% of Iran's gasoline.

- Total (France).
- Trafigura (Switzerland/Nethelands).
- Reliance Energy (India, Jamnagar refinery).
- Russia's Lukoil; Kuwait, UAE, Turkey, Venezuela (Petroleos de Venezuela), Singapore, the Netherlands, China, Turkmenistan, and Azerbaijan.

Iran is planning at least eight new or upgraded refinery projects to expand capacity to about 3 million barrels per day from 1.5 mbd.

Major Export Markets (2006):

- Japan ($9.9 billion).
- China ($9.2 billion).
- Turkey ($5.1 billion).
- Italy ($4.45 billion).
- South Korea ($4 billion).
- Netherlands ($3.2 billion); France ($2.7 billion); South Africa ($2.7 billion); Spain ($2.3 billion); Greece ($2 billion).

Major Imports (2006):

- Germany - ($ 5.6 billion);
- China - ($5 billion);
- UAE ($4 billion);
- S. Korea ($2.9 billion);
- France ($2.6 billion);
- Italy ($2.5 billion);
- Russia ($1.7 billion);
- India ($1.6 billion);
- Brazil ($1.3 billion);
- Japan ($1.3 billion).

Major Non-Oil Investments:

- Renault (France) and Mercedes (Germany) - automobile production in Karaj, Iran - valued at $370 million;
- Renault (France), Peugeot (France) and Volkswagen (Germany) - auto parts production;
- Turkey -Tehran airport, hotels;
- China - shipbuilding on Qeshm;
- Island, aluminum factory in Shirvan, cement plant in Hamadan;
- UAE financing of Esfahan Steel Company;
- India – a steel plant and a petrochemical plant;

- S. Korea – a steel plant in Kerman Province;
- S. Korea and Germany - $1.7 billion to expand the Esfahan refinery.

Trade With U.S. (2008) - $785 million (trade is severely restricted by U.S. sanctions).

Exports to U.S. - $102 million (pomegranate juice, caviar, pistachio nuts, carpets, medicines, artwork).

Imports from U.S. - $683 million (wheat: $535 million; medicines, tobacco products, seeds).

"Oil Stabilization Fund" Reserves - $12.1 billion (August 2008, IMF estimate). In mid-2009 estimates by experts say they might have now been reduced to nearly zero.

External Debt $19 billion (2007 est.)

Inflation 15% + (May 2009), according to Iranian officials.

Unemployment Rate 11%+

Sources:

Iran: U.S. Concerns and Policy Responses (Congressional Research Service), p. 11-12

CIA World Fact book, various press reports, IMF, Iran Trade Planning Division, CRS conversations with experts and foreign diplomats.