“Never give in and never give up”

The Impact of Sanctions on Tehran’s Nuclear Calculations

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Executive Summary

The U.S. has used its leverage over the international financial system to create the most comprehensive unilateral sanctions regime in history. This has played an instrumental role in convincing the European Union to implement its own set of unilateral sanctions with the central objective of changing Iran’s nuclear calculus and forcing it to agree to a deal that it otherwise would refuse or has already refused.

Though regime stakeholders openly acknowledge that sanctions have had a devastating impact on the Iranian economy, they also blame other economic factors such as mismanagement and corruption. Whether sanctions are the primary cause of the current economic malaise or not, for sanctions to achieve their objective of shifting Iran’s nuclear stance, stakeholders in the target regime must start building narratives that enable such a course correction, as well as start lobbying the government for a shift in policy.

This study – relying on over 30 in-depth interviews with senior Iranian political officials, analysts and members of the business community – shows that neither phenomenon has as of yet emerged in Iran in a measurable and impactful way.

First, Supreme Leader Ali Khamenei’s narrative – which portrays Western powers as a brutal, immoral group out to “get” Iran and to keep Iran underdeveloped and dependent – continues to dominate the discourse within the elite. It is unchallenged during internal debates and is further consolidated by continued external antagonism. And while deep divisions continue to plague the Iranian elite, little evidence has emerged to suggest that the infighting has softened Iran’s nuclear stance.

Second, though the private sector is deeply unhappy with the negative impact of sanctions and government policies on private sector activity, their private lobbying campaigns have tended to focus on securing concessions for themselves, rather than pushing for nuclear concessions to the P5+1.

Overall, Iran’s response to sanctions can be broken down into three separate but mutually reinforcing categories:

Adapting its economy to bend but not break. Iran’s negative economic trajectory has led it to adopt a so-called “economy of resistance.” To date, this has taken shape in five discernable ways.

- Maintaining a positive balance of trade through foreign exchange reserves and export controls.
- (Re)distribution of GDP by reducing oil revenue importance for the budget, while generating growing revenues from value-added tax, other taxes, and privatization.
- Providing basic economic needs with per capita oil export earnings of below $500. At an oil price of US$ 100 per barrel, that limit is reached even with oil exports reduced to below one million barrels per day.
- Increasing domestic refining capacity in order to use excess crude domestically, turn Iran into an exporter of refined products, and free up gas for exports.
- Shifting trade away from official banking to unofficial financial networks, and processing more transactions through barter trade and foreign exchange bureaus.
Increasing efforts to target Western and Israeli interests around the world. Iran’s efforts to work against Western and Israeli interests have increased over the past four years, though not necessarily successfully.

Tehran has further increased its support for Hamas and Islamic Jihad. When Israel attacked Gaza this past November, it was Iran that transferred technology for the construction of missiles that brought Israel’s major cities within range for the first time. Iran also appears to have invested more resources into its security and intelligence operations outside the country, as demonstrated by the alleged 2011 plot to assassinate the Saudi Arabian ambassador in Washington and no less than six targeted bombings against Israelis.

Another telling example emanating from Tehran is the recent uptick in cyber attacks. The targets have been high profile and intentional: Major American banks, the world’s largest oil company, and the world’s largest natural gas field.

Creating new facts on the ground with regard to its nuclear program. No data suggests that Iran’s nuclear program overall has slowed down over the course of the past four years. Its stockpiles of low enriched uranium and medium enriched uranium, and its installation of first and second generation centrifuges have all increased.

The program appears at best entirely unaffected by the sanctions or at worst partly driven by them in the sense that escalating sanctions as a bargaining chip also gives Iran the incentive to advance its program for the same reason. Perhaps more importantly, these measures seem to have increased Iran’s commitment to the program and reinforced the domestic political immunity it appears to enjoy.

Elements within the Iranian government contend that the continuation and acceleration of the program has also been in response to sanctions, serving three purposes: Convincing the UN Security Council that sanctions are futile; Raising the cost for the West’s alleged refusal to deescalate the conflict; and compelling the West to accept Iran’s right to enrich uranium.

The study concludes that it is highly unlikely that the regime will succumb to sanctions pressure at a time when its narrative remains unchallenged, key stakeholders are not visibly lobbying for policy shifts, no proportionate sanctions relief is put on the table by the P5+1, and capitulation is seen as a greater threat to the regime’s survival than even a military confrontation with the United States.
CHAPTER 1

Introduction

“We’re relying upon others, because we’ve sanctioned ourselves out of influence with Iran... in other words, we don’t have much leverage with the Iranians right now.”

- President George W. Bush, December 2004

The United States and many of its allies believe that the Iranian government seeks to develop the technical capability and material to build nuclear weapons on short notice — though U.S. intelligence believes that Tehran has not yet made the political decision to weaponize. For its part, Iran has long insisted that its nuclear program is for strictly peaceful purposes. In an effort to blunt Iran’s presumed ambitions and increase its leverage vis-à-vis Tehran, Washington has spearheaded a potent barrage of unilateral and multilateral sanctions. Together with on-again, off-again negotiations under the auspices of the United Nations Security Council, Washington has pursued a “carrot and stick” strategy — now called “dual track” — utilizing primarily negative inducements to convince Iran to change its nuclear policy.

Neither the sanctions nor the diplomacy component of the dual track policy has produced satisfactory results thus far.

At the time of writing, seven meetings between Iran and the permanent members of the UN Security Council plus Germany (P5+1) have taken place over a four-year span. Unlike most negotiation processes, the two sides came closest to a deal in their first meeting in October 2009. Since then, diplomacy has steadily devolved into an exchange of ultimatums and mutual escalation — with Washington and Tehran trading turns not being able to take yes for an answer. Consequently, the investment in the coercive sanctions instrument has grown significantly over the past four years.

The Islamic Republic has faced various sanctions since its inception in 1979, but the severity of U.S.-led sanctions enforced over the past year has taken even veteran Iranian officials by surprise. The recent combination of sanctions on Iran’s oil and banking sectors are estimated to have cut Tehran’s oil revenues by as much as 50 percent — from $100 billion in 2011 to approximately $50 billion in 2012. Does this mean sanctions are working? If so, have sanctions increased the likelihood of a compromise? Or are sanctions causing hardliners in Tehran and the West to dig in their heels and eschew the compromises that will be necessary for a peaceful solution to the crisis?

Iran sanctions are a highly politicized issue, with domestic political ramifications in Washington, Tehran, Tel Aviv and Brussels. Though sanctions have been the primary policy tool used by the West since the inception of the nuclear crisis, no study has been conducted to assess the effect of sanctions on


the Iranian government’s policies, decision-making process and psychology. Precisely because of their centrality, it is vital to provide a clear, informed picture of the impact of sanctions on Tehran’s calculations. Relying on over 30 in-depth interviews with senior Iranian political officials, analysts and members of the business community, this study aims to provide just that – measure the efficacy and impact of sanctions-based policies in changing the Iranian government’s strategic calculus. It does not seek to make the case for or against sanctions on Iran.

These interviews add an important new dimension to the issue, providing firsthand accounts of the thinking that underlies Tehran’s strategic decision-making with regard to sanctions. Other studies and commentaries have speculated along these lines, but we believe this is the first study to have direct in-country research to corroborate these views. To ensure the reliability of interviewees, their accounts have been crosschecked with other interviewees, and most importantly, with an array of verifiable economic, political and IAEA data. No statement has been taken at face value.

It would be desirable to be able to name the Iranian sources. However, given the sensitivity of this issue in Iran, this has not been feasible. In fairness, most of the media reporting in the U.S. and E.U. citing senior government officials on this topic is regrettably anonymous as well, even though they – unlike Iran – are not repressive authoritarian states.

This report is organized as follows. In the first section, a brief history of sanctions on Iran since 1979 will be presented, with an emphasis on the unprecedented blitz of sanctions that have been implemented over the past four years. Second, the various professed aim(s) of the sanctions and the logic through which they are supposed to work will be presented in order to unpack the logic and drivers behind them. Thirdly, an in-depth analysis of the sanctions regime will be presented with a focus on two vital measuring points to determine the successfulness of sanctions: 1) How various stakeholders inside Iran have – or have not – pressured the government for changes to Iran’s nuclear policy; 2) How foreign pressure has – or has not – prompted the Iranian government to make changes to its nuclear policy, and if so, in what direction.

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CHAPTER 2

History of Iran Sanctions

“I have decided to ask for an early meeting of the United Nations Security Council to impose international economic sanctions upon Iran. The Government of Iran must realize that it cannot flaunt with impunity the expressed will and law of the world community.” – President Jimmy Carter, December 21, 1979.

“We’ve imposed the toughest sanctions in history. It is having an impact on Iran’s economy.” – President Barack Obama, November 14, 2012.

Sanctions on Iran have taken on a life of their own as the relationship between Washington and Tehran has steadily deteriorated. Largely spearheaded by the U.S., sanctions began nearly 34 years ago in response to the Iran hostage crisis. After Iranian students attacked the American embassy and seized hostages, President Jimmy Carter first responded with sanctions that barred the U.S. purchase of Iranian oil. Upon deciding that military action was too risky – an assessment shared by each subsequent American president – Carter attempted to ramp up pressure on Tehran through a litany of sanctions: freezing Iranian assets in the U.S. and blocking all property within U.S. jurisdiction owned by Iran; embargoing U.S. exports to Iran; and banning all imports from Iran, along with prohibiting U.S. citizens from conducting various types of financial transactions in Iran. After the hostages were released, the U.S. lifted nearly all of these sanctions — each of which was issued directly by the White House, rather than Congress.

Carter’s two Republican successors — Presidents Ronald Reagan and George H.W. Bush — also used sanctions to press Tehran. Reagan again banned U.S. imports of Iranian oil and all other imports in 1987 because of Iran’s “active support of terrorism” and its “aggressive and unlawful action against U.S. flag vessels…in the international waters of the Persian Gulf.” Bush signed the Iran-Iraq Arms Non-Proliferation Act into law in 1992 due to concerns about Iran’s possible development of weapons of mass destruction. The law included provisions banning dual-use items that could be used for military purposes.

It was under President Bill Clinton, however, that sanctions became the centerpiece of U.S. policy toward Iran. In 1995, the American oil company Conoco signed a $1 billion contract to develop an oil field in Iran. Days later, Clinton signed an executive order banning U.S. development of petroleum resources in Iran.

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sanctions into a total trade and investment embargo. After the Republicans took control of the House and Senate in 1995, pressure on Clinton to escalate further resulted in the Iran-Libya Sanctions Act of 1996 (ILSA). With a stroke of the pen, the President authorized sanctions on foreign companies and individuals investing $20 million or more in one year in Iran’s energy sector, or selling threshold amounts of refined petroleum to Iran. Because of strenuous objections from European and Asian allies, however, ISLA was not invoked under the Clinton administration. In return, the European Union agreed to tougher rules on the sale of dual-use items to Iran. In 1999, in response to conciliatory gestures by then Iranian President Mohammad Khatami, Clinton allowed Iran to export carpets, caviar and pistachios to the U.S. and permitted the sale of U.S. food and medicine to Iran.

George W. Bush continued the precedent set by Bill Clinton and expanded the scope of sanctions on Iran over the duration of his presidency. In addition to renewing ILSA (which was subsequently renamed The Iran Sanctions Act [ISA]), the Bush administration gave birth to the new standard practice of sanctioning Iranian banks and their associated transactions. New sanctions were placed on Iran’s Revolutionary Guard and three of Iran’s largest banks, which in turn provided ammunition for a global effort to get foreign banks and multinational corporations to stop doing business with Iran. In addition to these unilateral American sanctions, Washington spearheaded the effort to secure three new rounds of sanctions at the United Nations Security Council. These new measures prohibited the sale of equipment that could aid Iran’s enrichment and reprocessing activities, and sanctioned Iranians companies and individuals related to those activities; sanctioned additional Iranian entities and banned Iranian arms transfers; and sanctioned even more Iranian entities, prohibited the sale of dual use items to Iran, and authorized inspections of Iran Air and Iran Shipping Line cargo if suspected of carrying materials related to weapons of mass destruction. During this time, the E.U. largely opposed unilateral American sanctions and sought to work around them when it suited their respective national interests. The dynamic of sanctions policy would slowly change, however, as President Bush gave way to Barack Obama.

Using America’s massive leverage over the international financial system, the Bush administration created a new model for sanctioning Iran. It also laid the foundation for creating international buy-in through the three rounds of sanctions at the UN. Upon entering the White House, Barack Obama retained the same priorities, policy vehicles, and many of the same personnel on Iran sanctions as his predecessor. Over the duration of his first four years in office, Obama signed into law the most comprehensive unilateral sanctions regime in history, led efforts to secure new multilateral sanctions at the UN Security Council, and played an instrumental role in convincing the European Union to implement its own set of unilateral sanctions.

Unilateral American sanctions have arguably inflicted the most pain on Tehran during Obama’s presidency. In July 2010, he signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA), which updated the aforementioned ISA with an array of punitive measures—two of which stand out: the sanctioning of providing gasoline and other fuels to Iran, and banning the sale of equipment or services that would help Iran increase its gasoline production capabilities. As these sanctions caused Iran’s imports to fall, the country was faced with potential fuel shortages, thereby forcing it to domestically produce gasoline that has caused chronic pollution in Tehran to reach even more deadly levels.

With the U.S.-Iran conflict no closer to a peaceful resolution after nearly three years in office, Obama authorized what has been described by American officials as the “nuclear option” in “Washington’s financial war against Tehran,” by way of the National Defense Authorization Act of 2011 (NDAA). These sanctions restrict the access of foreign banks to the U.S. financial system if they process petroleum transactions with

Iran’s central bank. Less than a year later, with congressional pressure unrelenting, Obama signed the Iran Threat Reduction and Syria Human Rights Act (ITRA). Building off of the NDAA sanctions from less than a year earlier, the key facets of ITRA cut off access to the U.S. market for companies doing business with Iran’s energy sector, and froze U.S. assets of persons, insurers and lenders facilitating repatriation of Iranian oil revenues and/or doing business with the National Iranian Oil Company and the National Iranian Tanker Company. Rep. Gary Ackerman (D-NY) left little to the imagination when describing the intent of this mixture of unilateral American sanctions: “The goal…is to inflict crippling, unendurable economic pain [in Iran]. Iran’s banking sector – especially its central bank – needs to become the financial equivalent of Chernobyl: radioactive, dangerous, and most of all, empty.”

Obama took office knowing that maintaining international unity was vital to robust sanctions implementation. He also knew, however, that Russian and Chinese resistance would only allow UN Security Council sanctions to go so far. To that end, the president focused much of his efforts on the aforementioned unilateral sanctions. He did, however, manage to secure one UN Security Council resolution that sanctioned Iranian entities; authorized countries to inspect Iranian cargo if suspected of carrying materials related to weapons of mass destruction; prohibited Iran from investing in nuclear and ballistic missile technology; and banned the sale of many heavy weapons to Iran.

Although the UN sanctions were more watered down than Washington would have liked, they did serve a key purpose not readily discernible to many: providing political cover and an impetus for the European Union to ramp up its unilateral sanctions on Iran. Three rounds stand out above the rest. The first round sanctioned 180 Iranian entities with asset freezes and travel bans. The second round forced the Society for Worldwide Interbank Financial Telecommunications (SWIFT) to end all transactions with Iranian banks blacklisted by the E.U. The third round came in the form of an E.U. embargo preventing Tehran from selling oil to member states.

Looking back at the trajectory of Iran sanctions during Barack Obama’s first term in office, one can’t help but notice what a difference four years can make. Clearly, Iran’s own actions – and Iranian President Mahmoud Ahmadinejad’s reckless rhetoric and conduct – made it easier to convert those previously skeptical of sanctions. The Islamic Republic’s economy has never truly been in great shape, but even the most ardent skeptic of sanctions will concede that Iran’s economic health today faces its greatest adversity since the end of the Iran-Iraq war in 1988. But does this translate into success for Western objectives vis-à-vis Iran? To answer that question, a clearer picture of the logic and aim of sanctions is needed.

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CHAPTER 3

Logic and Aims of Iran Sanctions

“We’re showing the Iranian government that its actions have consequences. And if it persists, [sanctions] will continue to mount, and its isolation will continue to deepen.”
– President Barack Obama, July 1, 2010.

Though sanctions have been at the center of the Obama administration’s Iran policy since November 2009, the motivations for and public pronouncements about the objectives of sanctions have varied. Below is a summary of the various objectives listed by U.S. officials:

1) Change Iran’s nuclear calculus – Sanctions serve as the primary tool to raise the cost of Iran’s nuclear pursuits. The overarching goal is to make the cost of continuing Tehran’s nuclear path too high to bear, thereby leading to a change in its nuclear policy. The logic behind this goal is three-fold: A) Devastate the Iranian economy with a tacit understanding that civilian Iranians will be hurt in the process; B) As sanctions take root and permeate Iranian society, the aforementioned civilians – together with various stakeholders – will pressure the government and potentially create regime-threatening protests; C) With the economy weakened – and new fissures created within Iranian society and among Iranian stakeholders – the Islamic Republic’s regional and international strategic objectives become too costly to continue at current levels.

2) Get the Iranians back to the table and make them to negotiate in good faith – A subset of point 1. This logic supposes that increasing the cost of Iran’s nuclear pursuits will change its internal calculus. As a result, this will force key stakeholders in Tehran to believe that returning to negotiations and seeing them through is the only avenue for ending sanctions and other forms of pressure that threaten their domestic, regional and international priorities.

3) Strengthen the credibility and leverage of pro-engagement camps – A key motivation behind sanctions is domestic politics in Washington, Brussels and Tehran. This logic implies that sanctions provide political cover for politicians in the aforementioned capitals that favor non-military solutions to the conflict between Iran and the West. In the U.S. and the E.U., sanctions serve as a shield against political attacks from neoconservatives who label negotiations with Tehran as a demonstration of weakness and naiveté. In Tehran, sanctions allegedly provide leverage for political factions arguing in favor of de-escalation and détente with the West – by serving as a demonstration of the consequences that hardline Iranian policies produce.

4) Prevent military action by the U.S. or Israel – This argument presents sanctions as an alternative to war by delaying Iran’s nuclear program and adding more time for diplomacy, and thus
eliminating the need for military action. American rhetoric during the Obama administration has stressed a preference to resolve differences over Iran’s nuclear program diplomatically, while also emphasizing “all options are on the table” — including war — to prevent Iran from acquiring a nuclear weapon. An offshoot of this argument describes the dynamic as it pertains to Israel. American and European officials have argued that sanctions on Iran are necessary to prevent an Israeli attack on Iranian nuclear facilities. For its part, Tel Aviv has laid down numerous red lines over the past decade in an effort to demarcate specific developments in Iran’s nuclear program that would trigger an Israeli attack.

5) Political signaling at home and abroad — The political signal sent by sanctions on Iran is intended to reach three key audiences: A) Show political constituents in the U.S. that Washington is increasing pressure on Tehran to unprecedented levels; B) Show Middle Eastern allies and foes that America is still in charge, and make an example of Iran for its challenge to “Pax Americana” in the region; C) Show the world that Iran is paying such a heavy price for its nuclear pursuits that no country should seek to emulate Tehran’s path to nuclear capability.

6) Maintain unity within the P5+1 — This logic infers that Washington must seek to maintain a multilateral approach toward Iran regarding the nuclear issue, because Tehran is highly adept at exploiting rifts in the international community. Sanctions are the baseline tactic that permanent members of the United Nations Security Council plus Germany (P5+1) can agree upon in an effort to maintain international unity around diplomatic efforts to place red lines on Iran’s nuclear program.

While these motivations for sanctions are not mutually exclusive, the central objective is to change Iran’s nuclear calculus and force it to agree to a deal that it otherwise would refuse or has already refused. In the absence so far of achieving that specific objective, the sanctions cannot be deemed to have been successful.
CHAPTER 4

The Internal Dynamic: Iranian Stakeholders’ Response to Sanctions

“We are against any sanctions against our nation. [Sanctions] will impose agonies on a nation who suffers enough from miserable statesmen.” – Mir-Hossein Mousavi, Opposition Leader and former Prime Minister, September 28, 2009

“The only effect that these unilateral sanctions will have on the Iranian people is that they will deepen the hatred and enmity towards the West in the hearts of our people.” – Supreme Leader Ayatollah Ali Khamenei, June 3, 2012

Sanctions have had a devastating impact on the Iranian economy. Though numerous regime stakeholders openly acknowledge this, they also blame other economic factors such as subsidy reforms, varying degrees of mismanagement, and long-standing corruption. Consequently, an accurate assessment of the precise impact of sanctions on the economy remains elusive.

Representatives from the Iranian Chamber of Commerce have said that 50% of the current economic predicament is a direct consequence of sanctions and the other 50% is due to failed economic policies.1 Mohsen Rezaei, secretary of the Expediency Council and former commander of the IRGC, believes that 40% of the current economic problems are due to external sanctions, and the remaining problems caused by mismanagement as well as the existence of corrupt networks that are “trying to benefit from the current chaotic situation in the economy.” The deputy speaker of the Iranian Majles, Mohammad Reza Bahonar, has said that external sanctions are causing 50% of the current economic difficulties, with the rest being the consequence of weak political decisions and structural issues.3

Whether sanctions are the primary cause of the current economic malaise or not, for sanctions to achieve their objective of shifting Iran’s nuclear stance, stakeholders in the target regime must start building narratives that enable such a course correction. This section will take a closer look at the state of play inside Iran in response to sanctions.

Understanding Iran’s Decision-Making Processes

Political power in Iran runs through a complex and multi-layered structure. Most decisions are made in a permanent

1 Interview with Iran Chamber of Commerce official in Tehran.


3 Interview with Bahonar on Iranian television. Aired on 29 October 2012.
interaction between diverse and sometimes competing power centers. Foreign policy decisions are no exception to this rule. The highest authority on foreign policy matters is the Supreme Leader, who relies on a number of councils as well as formal and informal institutions to advise him on foreign policy and national security. The most significant such entity is the Supreme National Security Council (SNSC), where representatives of various state organs (including military and security officials) convene to discuss foreign policy and national security issues. Other institutions such as the Majles National Security and Foreign Policy Committee (NSFP) play a marginal role in the overall power structure, but they are also represented in the SNSC.

The Process

While the president theoretically controls key levers of foreign policy and security issues (by heading the SNSC), there is no doubt that the Supreme Leader wields the highest individual authority over such matters in Iran. Article 110 of the Iranian Constitution gives the Supreme Leader the position of commander-in-chief of the armed forces and the power to declare war. According to the formal structure, the Supreme Leader works through other entities in exercising his control over the military. This is where the SNSC comes in as a key institution in the formal structure.

Saeed Jalili, a war veteran and former IRGC commander, currently heads the SNSC and plays an important role in setting the agenda. He has a close relationship with both Supreme Leader Ayatollah Ali Khamenei and President Mahmoud Ahmadinejad. Khamenei has final say over all SNSC decisions, but he listens to the advice offered by SNSC members and then makes a decision. SNSC sessions that discuss critical foreign policy and security matters usually take place in the presence of the Supreme Leader. If the Leader is not present, Jalili will seek an audience with him to report and get Khamenei’s feedback. Former chief nuclear negotiator, Hassan Rohani, states in his book that key decisions were made in a smaller circle of SNSC members mainly focusing on Ayatollah Khamenei and the heads of the three branches of government.4

Explaining the general characteristics of the “velayat-e fagih” regime (the rule of the supreme jurisprudent), Khamenei stated on 8 September 2011: “The ‘absolute rule of the velayate fagih’ means flexibility of the regime. It means that the entirety of decision-making organs under the supervision of the leader, continuously consult and opt for decisions that are better and more complete. It means that we undergo adjustments and expand our regime to achieve progress for the country.” Khamenei also underlined the following nuance: “A wrong interpretation about ‘flexibility’ is to believe that it is equal to ‘deviation’ and to “giving up to external pressure.””5

4 Hassan Rouhani, National Security and Nuclear Diplomacy (2011)
5 Full text of Khamenei’s speech available at: http://english.khamenei.ir/index.php?option=com_content&task=view&id=1521&Itemid=4
These two quotes describe the process and also the professed core value in Iran’s foreign policy decision-making:

- The process is shaped by ongoing consultations in various councils (mainly SNSC, but also in other formal and informal interactions with state officials, the Expediency Council, the clergy and military commanders) until a policy is formulated.
- The core value is “not to give in” to external pressures. Iran’s foreign policy has evolved around the notion of “independence,” defined in the context of not allowing other countries to “bully” you or have undue influence on your policies.

These statements are a reflection of the continuous bargaining process that takes place among diverse interest groups in Iran. However, it is important to understand that some of the power centers and personalities are inside the closest circle of decision-makers while others are on the margins. Graph 4.1 depicts the various players in Iran’s foreign policy and national security apparatus and their respective positions:

Our interviews underline that whenever a decision is made inside the closest circle around Khamenei, the policy will stand and not be challenged by other stakeholders. However, in situations where multiple layers of stakeholders and institutions are involved in the decision-making, it is more likely that decisions will be delayed as another player or interest group could undermine the initiatives of one player. Ongoing bargaining among formal and informal stakeholders usually characterizes decision-making in Iran. One may argue that this is not unique to the Iranian power structure, but what is perplexing is that in many situations, competing stakeholders push for divergent agendas, which in turn sends out confusing signals to the outside world.6

Despite the infighting and competition for power, all key factions have one objective in common: the survival of the regime. Therefore, at the end of the long bargaining processes, most regime insiders view their critical decisions to be pragmatic and helping to secure the interests of the Islamic Republic. As such, the extent to which the nuclear standoff affects the security and sustainability of the Islamic Republic is an important question for key constituents.

**Khamenei’s View**

Supreme Leader Khamenei has remained steadfast in his approach to sanctions. The escalating sanctions regime has enabled him to strengthen a powerful pre-existing narrative that portrays Western powers as a brutal, immoral group of governments out to “get” Iran, and that their core interest is to keep Iran underdeveloped and dependent. This narrative serves to maintain unity in a fragmented power structure, through:

- Sustenance of the image of an unrelenting enemy.
- Justification of the need for a feared security apparatus as a means to counter that enemy.
- Mobilizing the support of a minority segment of society who can be paraded as “popular support” when needed – on the anniversary of the revolution, during elections, etc.

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6 A critical aspect that must be understood in Iranian politics is the distinction between constructive power and obstructive power. While very few power centers have the ability to push through their own agenda and decisions, a large host of entities and individuals have the power to obstruct decisions. Foreign policy decisions are often sacrificed in such obstructive manners.
As long as the aforementioned narrative of continued Western animosity remains in place, Khamenei will justify the empowerment of his military-security apparatus as a necessary instrument for countering threats against the Islamic Republic.

To underline his view on external pressure, Khamenei said on 7 January 2013 that “the sanctions are meant to strain the people's patience, incite the people to oppose the Islamic Republic, and increase the pressure on Iranian officials in order to alter officials' calculations” — in other words, the image of the strong external enemy remains in place and his continued attitude is “not to give in” to this enemy. Khamenei’s recipe for countering the sanctions — which he describes as “economic warfare” — has been dubbed the “economy of resistance,” a vague term for a greater degree of protectionism, support for domestic industry, and lowering the Iranian economy’s dependency on oil exports.

There are interests and structures that can challenge Khamenei’s narrative, but they need some degree of justification to do so.

The multi-layered nature of the Islamic Republic is evident in the following phenomenon: To provide some degree of flexibility, Khamenei allows experiments, but does not commit to them until he gets a sense of security about the initiatives — an Iranian version of “leading from behind.” At the same time, no one person is the “responsible” and “accountable” decision-maker — even the Supreme Leader can hide behind an array of institutions when he needs to justify or delay a decision.

As such, a critical question is how key constituencies (especially those layers of power that are closer to the Supreme Leader) read the current state-of-play.

### The Dominant Narrative

While there is unanimous acknowledgement that sanctions have created economic and social costs for Iran, individuals close to the core of Iran’s power structure are relishing the narrative of resistance. According to this line of thought, while Iran suffers economically, it is also gaining newfound respect on the international stage due to its refusal to succumb to Western pressure. “Those who are witnessing how Iran is managing its enormous challenges develop a new level of respect for Iran, and that has given Iran a new credibility on the international stage,” one influential parliamentarian remarked.

“Iran has become a role model for developing countries and there is a greater willingness among developing nations to work and trade with Iran.” While the idea that Iran is viewed as a role model or with greater respect is certainly debatable, it is an argument that is frequently cited by officials as a vindication of their narrative.

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7 Survival of the Islamic regime is an important factor in decision-making and behavior. As long as it provides the basis for the regime behavior, it can be easily justified. Even the Expediency Council — which Rafsanjani heads — is an institution to provide for the “expediency of the regime”, i.e. an instrument to prolong the life of the regime.

8 Full text of Khamenei’s speech available at: http://english.khamenei.ir/index.php?option=com_content&task=view&id=1737&Itemid=4

9 One good example of such an experiment was direct U.S.-Iran talks over Iraq in 2006.

10 Interview with senior Majles deputy who is relatively influential in the top layers of the regime.
Moreover, this narrative contends that as long as Iran stands firm, global sanctions fatigue — including in Europe — will ultimately cause the collapse of this policy. One senior decision-maker in Tehran spoke confidently of the belief that Europe cannot stomach a return to sanctions-based policies reminiscent of those imposed on Saddam Hussein’s Iraq. This in turn will slowly unravel the coalition against Iran: “The sanctions — and especially the continuation of these sanctions — have exposed Washington’s true character to many international players, including Western countries,” he told us. “I believe that the Europeans won’t continue to blindly support the U.S. strategy, and the time will come when the E.U. or some of the European countries will go a different path and Iran will wait for that break.”

A Majles deputy close to Speaker Ali Larijani echoed this sentiment, expressing a degree of skepticism regarding Europe’s dedication to sanctions: “In the Majles presiding board, there is an understanding of what the U.S. is doing. We understand that they have a strategy to antagonize Iran. However, the big puzzle is the E.U.’s behavior. It seems as if the Europeans have fallen into an American-Israeli trap and they don’t know how to come out of it. If they continue this way, they will lose more and more of their economic foothold in Iran.”

There is also an attempt to capitalize on the impact of sanctions to influence the Iranian populace’s attitudes towards the West, which they believe will further strengthen Khamenei’s narrative. Rather than denying the negative impact of sanctions, decision-makers in Tehran are beginning to acknowledge them to vindicate the dominant regime narrative of Western hostility towards Iran and to influence attitudes towards the U.S. negatively. “It’s true that the sanctions are imposing an economic cost on the Iranian people and the regime, but they are also imposing a social cost on the U.S.,” one influential policymaker told us. “The Iranian people are learning more about the hypocrisy and the true image of the West. I believe that the Iranians are becoming more and more anti-Western and that will have long-term costs for the Western countries in our region.” Although it is unlikely that sanctions will turn the entirety of Iran’s population against the West, Iranians inside Iran have increasingly voiced their displeasure with both the government and sanctions that create new hardships. A senior Iranian diplomat echoed as much in our interview with him: “The society has become nuanced in its political awareness. It can analyze to see how far the current economic conditions are a result of Western pressure and Western double standards and to what extent it is the doing of the Iranian government.”

Though question marks exist in regards to polling in Iran, a long series of studies — including a recent scientific poll conducted by Gallup — supports the notion that a strong plurality of the Iranian population tends to put the blame on the U.S. rather than on the Iranian government. If this trend holds, the regime will find more opportunities to strengthen its narrative of resistance and blame the West for Iran’s deteriorating economy as the duration and bite of sanctions intensifies.

11 Interview with former high-ranking minister who is still influential in the key foreign policy and national security circles.
12 Interview with Majles deputy who is close to Ali Larijani.
13 Interview with former high-ranking minister who is still influential in the key foreign policy and national security circles.
15 Interview with senior Iranian diplomat.
Are Sanctions Inducing the Emergence of a Competing Narrative?

A critical step for sanctions to succeed in changing Iran’s nuclear calculus is to help create room for the emergence of a competing narrative that paves the way for a shift in policy. Though the repressive nature of the Iranian regime and its efforts to eliminate any public debate about the nuclear issue renders the emergence of such a public narrative next to impossible, this does not hold true for narratives within the inner circles of the regime. Thus far, no such counter-narrative appears to have emerged among influential elements of the Iranian elite.

“Even though regime members outside the core can have a voice and influence, it is sad to say that none of them actually has a strategy on how to amend the national security policy,” a regime insider explained. “Therefore, the core around Ayatollah Khamenei is not only the most powerful, but also the only group that has a strategy, i.e. the ‘strategic distance and antagonism’ to the U.S.”

Our interviews indicate that there currently is no competing strategy to the narrative favored by Khamenei and the layers of power closest to him. While mainstream conservatives may be more amenable to negotiations and a nuclear compromise, they have not formulated a strategy accordingly, as they feel that the dominant narrative will hold firm. The other reason for the lack of a counter-narrative can be found in the failure of Western countries to paint and communicate the alternative scenario. There are no indications how the dynamics of nuclear negotiations would change if Iran changed its behavior. Removal or suspension of some sanctions appears not to be enticing enough for any of the interest groups. Consequently, the core narrative is not only unchallenged during internal debates, but it is further consolidated by continued external antagonism.

A former high-level diplomat and Foreign Ministry official described the result of this trajectory: “The status of being in an ‘economic war’ means that a lot of the actual issues in the country cannot be debated, which is also impeding the political development of the country. The situation has undermined the position of the reformists and empowered the hardline elements.”

Iranian intellectuals critical of the regime — even though they have diverging views on whether the Iranian government should show more flexibility, or whether Western countries should adopt a new policy — tend to agree that the sanctions regime only proves the dominant anti-Western narrative, making it very difficult for any other perspectives to emerge. There is also agreement with the notion that external sanctions have undermined the domestic process of democratization, which in turn has helped exacerbate long-standing efforts by hardline forces to dominate Iranian politics.

A former mayor of Tehran candidly described his belief that both Iran’s elite and its society do not wish to see the “destruction” of Iran. Therefore, the reaction will be harsh to any internal or external push that would bring Iran to the brink of “economic destruction.” The problem, he says, is that the “majority of the elite cannot gauge whether the source of the sanctions issue is inside or outside the country.”

17 Interview with well-positioned businessman with links to the security apparatus.

18 Interview with former high-level diplomat and foreign ministry official.

19 Interviews with five Iranian intellectuals who wished to remain anonymous.

20 Interview with former Mayor of Tehran.
Stark divisions among the Iranian elite are unmistakable. However, those divisions do not appear to have affected regime cohesion around the nuclear issue or on the response to sanctions. And if the testimony of elite insiders is to be believed, sanctions have helped strengthen cohesion rather than intensify rifts. Numerous Iranian decision-makers insisted – Ahmadinejad’s belligerence notwithstanding – that sanctions were unifying rather than dividing the Iranian elite. A current, senior minister articulated his view accordingly: “The main objective of these sanctions has been to impose regime change or at least to weaken the Iranian regime. They have failed in that objective and in fact, they are strengthening the core of the Iranian regime, because they have united regime constituents. Their main cost on Iran is that the sanctions have undermined our country’s ‘human geography’.”

Another current official with influence over Iran’s economic policies shared this sentiment, telling us that “Western governments thought that Iran would collapse economically after the CBI sanctions. Well, now they know that they have failed. If they continue this way, it will just strengthen Iran’s resolve to confront the West.”

There is understandably a concern that regime officials will tow the party line in interviews, thereby not providing a clear picture of the thinking inside the system. When we crosschecked these interviews in our conversations with former regime officials and regime-critical intellectuals, a similar sentiment emerged. A former Deputy Foreign Minister candidly described to us a line of thinking that exists beyond the Supreme Leader’s inner circle: “It was obvious to us that the sanctions pressure will increase and it was also clear to us that the main target was to weaken the regime, but that compelled us to stay strong, work together and prove the Western strategy wrong.”

A former senior Iranian diplomat shared this sentiment, telling us that he believes continued sanctions will further harden Iran’s position in future diplomatic negotiations. It is reasonable to believe that beyond these statements of bravado, a more conflicted situation exists. The critical notion, however, is to see whether those internal divisions are impacting the strategic calculations of the government.

Our interviews indicate that the private sector is unhappy about the current state of affairs, especially the negative impact of sanctions, as well as government policies on private sector activity. But in their private lobbying campaigns, rather than pushing for a different foreign policy, they have tended to focus on lobbying the government to secure concessions for the private sector, acknowledging that they do not have the necessary political influence to change the nuclear policy. The main forum for such lobbying has been regular sessions entitled “Dialogue Between the Iran Chamber of Commerce and the Government,” which involve the president of the Chamber (Dr. Mohammad Nahavandian) and key ministers (Ministers of Finance, Commerce and Industry, Agriculture, Petroleum, etc.). Ayatollah Khamenei’s decision to declare the current calendar year as the “Year of Domestic Capital and Domestic Industry” is likely related to these lobbying efforts.

21 Interview with current minister who is present in SNSC meetings. His reference to “human geography” refers to the socio-economic costs of sanctions and their negative impact on Iran’s economic development.

22 Interview with current official in the country’s business community who has influence over trade and economic policies.

23 Interview with former deputy foreign minister who is still close to the foreign policy and national security circles.

24 Interview with former senior Iranian diplomat.

25 This is what Khamenei entitled the current Iranian year in his March 2012 New Year speech. Available at: http://english.khamenei.ir/index.php?option=com_content&task=view&id=1620&Itemid=4
A number of concessions that the private sector has secured so far include:

- Inclusion of numerous product categories of imports in the “currency exchange” priorities so that such companies can use favorable currency exchange rates for their imports.\(^{26}\)
- Delaying the implementation of the second phase of subsidy reform (This was achieved through direct interaction between the private sector representatives and the Majles).\(^{27}\)
- Finalization of a decree by the Expediency Council on “Drive to Self-Sufficiency in Industry, Agriculture, Defense and Security” — a document to promote local industry and local production. This was also the result of lobbying with the Expediency Council.\(^{28}\)
- Issuance of permits for private sector companies to participate in the exportation of petroleum (including crude oil) and petrochemical products.\(^{29}\)

Most recently, Ayatollah Khamenei signed a decree on “General Policies on Domestic Production and Protection of Iranian Labor and Capital.”\(^{30}\) The latest evidence that domestic industry is lobbying to improve the investment environment manifested itself when the Supreme Leader’s decree highlighted 23 new benefits to Iran’s private sector, including but not limited to:

- Promotion and protection of the production of strategic goods, as well as goods that are required for domestic manufacturing.
- Completion of the value chain of raw materials and products, and an end to the sale of raw materials.
- Promotion of production of those goods in the domestic market whose competitive production will lead to net hard currency revenue for the economy.
- Management of hard currency resources emphasizing the needs for domestic production and entrepreneurship aiming at maintaining the value of the national currency.
- Increase in the role of the private sector and cooperative sectors in domestic production.
- Breaking of all monopolies in production, commerce and consumption.

While it is valid to say that a number of the aforementioned initiatives will also benefit the semi-governmental sector, the central point is that the Iranian business community (private or semi-governmental) is mainly focused on improving its own operational and investment climate as opposed to lobbying towards a change in nuclear strategy. Moreover, while Western intelligence suggests that the Iranian business community has put pressure on Khamenei to shift his nuclear stance, our interviews did not confirm this. However, it could be verified that businesses had sought concessions from the Iranian regime.

In conclusion, in spite of the bite of sanctions, Khamenei’s narrative of resistance continues to dominate and key stakeholders seem more intent on seeking concessions from the government rather than pressing for a change in the nuclear strategy.

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\(^{28}\) For more on this decree, see: http://www.hamshahrionline.ir/details/197372


CHAPTER 5

The External Dynamic: Tehran’s Response to Sanctions

“Of course the sanctions have had an impact as well, but those could be remedied in short order if the Iranian government were willing to work with... the international community in a sincere manner.” – Secretary of State Hillary Clinton, October 3, 2012

“They pretend that if the Iranian nation gives up nuclear energy, the sanctions will be lifted. They are lying.” – Supreme Leader Ayatollah Ali Khamenei, October 10, 2012

Iran’s response to sanctions can be broken down into three separate but mutually reinforcing categories: 1) Adapting its economy to bend but not break; 2) Increasing efforts to target Western and Israeli interests around the world and 3) Creating new facts on the ground with regard to its nuclear program. The logic behind Iran’s approach appears to be simple: tit for tat. A closer look into each of these three categories demonstrates a regime that seeks to absorb the blow of sanctions, raise the cost of its isolation, and project strength – all in an effort to ensure survival and serve its perceived interests.

I. Adapting its Economy to Bend, Not Break

Iran has been under various waves of sanctions over the past three decades, but the escalatory measures that emerged in 2012 – including sanctions on Iran’s Central Bank and E.U. sanctions on the purchase of Iranian oil – have had a significant impact on the Iranian economy.

The Pain of Sanctions

Most politicians and pundits agree that 2012 was the most tumultuous period for the Iranian economy since 1994, when an external debt crisis triggered a major recession. In one calendar year, GPD per capita declined by nearly eight percent; inflation increased by over ten percent; and unemployment inched close to 20%.\(^1\) In a rare admission by the minister of petroleum, Rostam Qassemi, he conceded that Iran’s crude oil export revenues fell by about 40%.\(^2\)

The long-term impact of sanctions includes loss of new investments and declining technology, which in turn undermine the long term sustainability of oil and gas production. In the short term, the corresponding decline in direct revenues means that:

- Iran will have a growing budget deficit problem. This year, the budget deficit stood at about 3.5% of GDP. If it grows further, it will lead to further inflationary impacts.
- The government will have to limit imports in order to prevent a trade and payments deficit.

1. Iran Economics Magazine (Eghtessade-e Iran)
Iranian industry is suffering extensively as a result of sanctions, mismanagement, corruption, and corresponding negative economic phenomena. Smaller industrial units are sandwiched between sanctions-related impediments and increased energy prices, as well as inflation. Larger industrial units such as the automotive companies have been forced to reduce production (in some cases, up to a 40% decline) and lay off staff.

Perhaps the most notable example of how Iran’s economy is suffering can be seen in the currency dive. The unofficial value of the Rial has gone from Rial 20,000 to the US dollar in January 2012 to Rial 33,000 in January 2013 (see graph 5.1). The Rial began to fall immediately after the CBI sanctions were adopted in late December 2011, and fell even further after the E.U.’s oil sanctions took effect in July 2012. In October 2012, the government tried to manage the market by introducing a new rate via a currency exchange mechanism, which was initially successful but failed to provide a sustainable flow to the various economic sectors that needed hard currency for transactions. As such, the Rial has lost tremendous value both in official and unofficial trade. Most economists argue that the collapse of the Rial was partly expected due to government policies and their inflationary impact. However, the result of sanctions to-date appears twofold: 1) Psychological; 2) The difficulty of repatriating Iran’s hard currency revenues as a result of banking sanctions.

**Tehran’s Response: Economy of Resistance**

Iran’s increasingly negative economic trajectory has led to a greater degree of debate on which economic policies should be adopted in an effort to adapt. Regime principals subsequently termed the so-called “economy of resistance” as Iran’s response to sanctions, and some even contend that it can help Iran solve some of its structural and long-standing economic problems. Officials close to Petroleum Minister Rostam Qassemi have told our team that the view inside the ministry is that the economy is far from collapsing, and efforts to circumvent the impact of sanctions have taken shape through increasing the domestic production of refined products and penetrating regional markets for petroleum products. Other key facets of Iran’s efforts to adapt include:

**Positive Balance of Trade:** The economy as a whole is still producing a positive balance of trade. It can resort to major foreign exchange reserves (mainly kept in gold), which in turn can sustain the economy’s imports for approximately 17 months in case all export revenues collapse in the future – which is unlikely because there is no global consensus on the implementation of a total trade embargo on Iran. Iranian imports are highly regulated and controlled. While the government tightly controls the importation of basic goods such as food and medicine, all other imports are controlled.
via customs or banking regulations. Consequently, the government can regulate imports to a level that ensures that the economy as a whole will produce a positive balance of trade. For example, while per capita imports stood at US$ 945 in 2011, they are projected to drop to US$ 699 in 2012.\(^4\) This means that as a result of tight import controls, Iranian society is either deprived of some products (such as high cost medical equipment) or that the quality of imports declines.

It should, however, be noted that despite positive balances of trade and payments, the Iranian economy is producing a negative balance of capital account — in other words, the economy’s asset base is in decline due to sanctions and mismanagement. In the long run, this negative balance of capital account will have high costs for the Iranian economy, especially as Iran needs to generate jobs to respond to the country’s young demography.

\section*{GDP (Re)Distribution}

The distribution of Iran’s GDP is an indicator of how dependent the economy is on various sectors, and its interaction with the outside world. As Graph 5.2 indicates, the economy is still service-based with most services relying on domestic subcontractors.

As such, the vulnerability of the overall economy can be contained by appropriate policies. The significance of the petroleum sector is primarily the fact that it still generates approximately 75% of Iran’s hard currency revenues, as well as approximately 50% of its budget sources. As far as budget dependency on oil revenues is concerned, the current trend shows a decline of oil revenue importance for the budget, while the government can generate growing revenues from value-added tax (VAT), other taxes, and privatization (see Graph 5.3).

As a consequence of sanctions, the Iranian government cannot export the same levels of oil as years past; thus, it will have to fill the budget gap through other sources. VAT was introduced three years ago and stands currently at 6%. It is conceivable that the level of VAT will be increased to fill some of the gaps. Furthermore, through privatizing government companies, the Treasury will generate revenues, so a financial collapse of the Iranian government in the short run appears unlikely.

\section*{Per Capita Oil Export Revenue}

Another indicator of the Iranian economy’s resiliency is per capita oil export revenue. As Graph 5.4 shows, for most of the past three decades, this indicator has been below $500. However, in 2013, with falling oil exports at current prices, the per capita revenue should stand at approximately $700, which can sustain the Iranian economy despite the barrage of challenges.

The government has managed to provide the basic needs of the Iranian economy with per capita oil export earnings of below $500. At an oil price of US$ 100 per barrel, that limit would be reached — even with Iran’s oil exports reduced to below one

\[\text{Graph 5.2} \quad \text{Iranian GDP Distribution by Sectors (2011 figures)}\]

\begin{center}
\begin{tikzpicture}
\begin{scope}
\node (services) at (0,0) {Services 48%};
\node (industry) at (90:3) {Industry 41%};
\node (agriculture) at (210:3) {Agriculture 11%};
\node (petroleum) at (330:3) {Petroleum: 22.2\%};
\node (manufacturing) at (270:3) {Manufacturing: 11.0\%};
\node (construction) at (180:3) {Construction: 4.7\%};
\node (utilities) at (90:3) {Utilities: 1.7\%};
\node (mining) at (0:3) {Mining: 1.0\%};
\end{scope}
\end{tikzpicture}
\end{center}

\textbf{Source: Statistical Center of Iran}

\(^4\) Based on statistics presented in “Eqtessade Iran” (Iran Economics) – January 2013.
Graph 5.3  Dependency of State Budget on Oil Export Revenues

Source: Atieh International GmbH, Vienna

Graph 5.4  Per Capita Oil Export Income for Iran 1980 - 2012

Source: Atieh International GmbH, Vienna
million barrels per day. At the same time, Iran is increasing its capability to export natural gas. This can help ensure that Iran’s overall per capita petroleum export revenue remains at a level that allows the government to manage the economy’s hard currency needs. Furthermore, Iran is investing in additional domestic refining capacity so that it can add value to the oil that it does not export. Similarly, Iran is planning to invest in a major refinery in Pakistan, which would facilitate an export of Iranian crude to neighboring Pakistan for refining purposes. Though such changes require initial investment, the medium to long term effect for Iran’s economy can be positive, as it may increasingly become an exporter of petroleum products rather than crude oil.

**Energy Production and Use:** Both Iran’s crude production and exports have been hit severely by sanctions. Iran has been stockpiling its crude oil on tankers and in bunkers, but appears to be running out of space. There are indications that Iran will try to increase domestic refining capacity in order to use the excess domestically. The Ministry of Petroleum has started issuing permits for small-scale refineries (capacity of approximately 50,000 barrels per day of oil) to private and semi-governmental companies. The goal of these refineries is to boost Iran’s domestic refining capacity and turn Iran into an exporter of refined products after a two to three year working period. The contracts for these projects are largely awarded to domestic companies, thereby potentially creating a core constituency within the regime that has at least a short to medium-term economic interest in maintaining the status-quo conflict with the West.

Iran can also maneuver between its oil and natural gas usage domestically. Over the past few years, with priority given to domestic usage of energy resources, there had been an emphasis on replacing crude oil with natural gas in order to increase the role of gas domestically and free up oil for export. That trend has now been reversed, which means that some of the excess oil will be used domestically to free up gas for exports. The increase in energy and fuel prices has led to a decline in domestic energy consumption. The combined energy savings (in gas, electricity and fuel consumption) is equivalent to the consumption of 100 million cubic meters per day – approximately 20% of the country’s gas production. The gas and energy resources that are freed up can be used for other purposes, such as injection into oil fields (to increase oil production), gas exports, and electricity production and exports.

**Processing Transactions:** Sanctions have shifted a significant section of Iranian trade away from official banking to unofficial financial networks, thereby forcing Iranian traders to rely on two systems to be able to import their goods:

- Barter trade, i.e. export of Iranian goods in return for import of foreign goods – this is a system that many Iranian traders knew from the Iran-Iraq war era. Even if not barter trade, there is a tendency for importers to export goods, keep the hard currency revenue outside Iran and to use the hard currency to import needed products and services. This way, they avoid Iranian banks (and hence banking sanctions).

- Utilization of foreign exchange bureaus as opposed to regular banks. Through using such foreign exchange bureaus, a growing segment of Iranian financial transactions are not going through the banking system, which increases the likelihood of corrupt financial dealings, money laundering, etc.

According to the latest Central Bank estimates, 21.6% of the Iranian economy is considered “underground economy,” including growing smuggling activity to circumvent sanctions issues. Iranian traders are increasingly compelled to use smuggling routes, which at a minimum empower corrupt business networks in neighboring countries. According to Iran’s Minister of Industry, Mines and Commerce, Mehdi Ghazanfari, “41% of the hard currency needed for imports in the first half of the current Iranian year were provided by non-banking routes.” This phenomenon was later echoed by OFAC Director Adam Szubin in January, when he said: “Increasingly we’re seeing [the Iranians] turn to trading houses in third countries to facilitate movement of money that would normally go through a bank.”

II. Targeting Western and Israeli Interests Around the World

The Islamic Republic’s efforts to work against Western and Israeli interests are hardly a new phenomenon – but the increased activity over the past four years is noticeable though not necessarily successful.

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6 Interview with Senior Advisor in the Ministry of Petroleum.


Over the past years, Tehran has further increased its support for Hamas and Islamic Jihad. When Israel attacked Gaza this past November, it was Iran that transferred technology for the construction of missiles that brought Israel’s major cities within range for the first time. From Tehran’s vantage, the “Axis of Resistance” was given a boost by a direct Iranian escalation that officials in Tehran for the first time openly took credit for. On this point, the head of Iran’s parliament, Ali Larijani, was unequivocal: “We proudly say we support the Palestinians, militarily and financially…The Zionist regime needs to realize that Palestinian military power comes from Iranian military power.” Tehran both escalated the quality of weaponry it provided Hamas and found itself having – as a result of its declining popularity in the Arab Sunni world following the Arab Spring – an interest in aggressively claiming credit for Hamas’s improved fighting skills. Larijani also spelled out Iran’s response to sanctions in plain language for the West: “We may have inflation, unemployment and other economic issues in our country [read: sanctions]…But we are changing the region, and this will be a big achievement.”

Iran’s response to sanctions, however, has not been limited to support for foreign allies. Over the past two years, escalatory measures have become longer-term investments that are operationalized with greater frequency. A senior Iranian diplomat was candid in his assessment of this growing trend: “In response to the sanctions regime, Iran is now investing a lot more money into its security and intelligence operations outside the country.” From late 2011 onward, much indicates Iran has matched its actions with its words – though rarely successfully.

In October 2011, President Obama and Attorney General Eric Holder announced that the U.S. had foiled an Iranian plot to assassinate the Saudi Arabian ambassador in Washington DC. If correct, this was a new level of escalation by Iran – brazen by even its own standards. According to U.S. officials, the alleged plot was financed and backed by the Iranian government, and involved the Quds Force – the branch of the IRGC responsible for foreign operations. Three months after the plot was foiled, Director of National Intelligence John Clapper candidly acknowledged a tit-for-tat cycle of mutual escalation between the U.S. and Iran in his Senate testimony: “The 2011 plot to assassinate the Saudi Ambassador to the United States shows that some Iranian officials – probably including Supreme Leader Ali Khamenei – have changed their calculus and are now willing to conduct such an attack in the United States in response to real or perceived U.S. actions that threaten the regime. [Emphasis ours]” Some U.S. officials believe that the Saudi plot was deliberately botched in order to simply send Washington a signal (with plausible deniability): Iran has the ability and intent to strike on U.S. soil if Washington strikes Tehran. The U.S. response has been to carefully study potential targets and operatives Tehran might use.

As 2011 turned into 2012, Iran’s security and intelligence operations reportedly picked up the pace, unleashing a barrage of bombings around the world. On February 13, Israel accused Iran of being behind twin bomb attacks that targeted Israeli embassy staff in India and Georgia. Two days later, three Iranians were detained on suspicion of connection to bombings in Thailand. On July 1, two Iranian men who were arrested in Kenya subsequently led government officials to a 33-pound stash of explosives and admitted they were plotting to attack U.S., Israeli, Saudi, or British targets. On July 7, Israeli accused Iran and Hezbollah of plotting to attack its citizens in Cyprus after police arrested a Swedish passport holder of Lebanese descent for tracking the movements of Israeli tourists. Later that month, Israel accused Iran of ordering a bomb attack on an Israeli tour group in Bulgaria in which at least seven were killed and 32 injured. Six months later, in February 2013, the Bulgarian government implicated Hezbollah in the July 2012 bombing. The U.S. government reportedly supports the view that Iran was also behind the bombing, based on intercepted communications.

10 Interview with senior Iranian diplomat.
When describing the logic behind this dynamic, a senior Iranian government official did not mince his words: “The budget allocations to the Ministry of Intelligence and other security and intelligence operations inside the country have been increased enormously, paving the way for a larger degree of intelligence operations against Western interests, such as cyber warfare, going after spy rings, etc....In the name of fighting an economic war, many projects are being approved and implemented that would have never received a budget under normal circumstances.” While the rest of the population suffers from the yoke of sanctions, to the security apparatus, they are treated as a blessing in disguise. The same official explained how the heightened animosity with the West has benefitted the security apparatus: “Why would we want to bring about an end to the sanctions? In the current situation, we can apply for any type of budget and any resources and the state allocates and approves all that we need. If there would be no economic war or no sanctions, then our resources would become limited.” This perspective appears to be unique to the security and intelligence services. Other elements of society as well as within the regime itself concede the difficulties sanctions have brought on Iran.

Another telling example of these new projects emanating from Tehran is the recent uptick in cyber attacks. The targets have been high profile and intentional. In September, Iranian hackers reportedly targeted Bank of America, JPMorgan and Citibank, with sources saying that evidence suggested the hackers targeted these banks in retaliation for their enforcement of sanctions against Iran. A month later in October, U.S. intelligence says Iranian hackers attacked Saudi Aramco – the world’s largest oil company – causing 30,000 computer workstations to be taken offline and replaced. A few days after the Aramco cyber attacks, Tehran allegedly hit the computer management system of Qatar’s RasGas Natural Gas Company, which operates the world’s largest natural gas field. Defense Secretary Leon Panetta called these cyber attacks “probably the most destructive attack the private sector has seen to date.”

III. Creating New Nuclear Facts on the Ground

The primary purpose of sanctions is to change Iran’s nuclear calculus by raising the cost for its continued defiance. Early signs of success would include a slow-down of Iran’s nuclear activities, increased Iranian willingness to negotiate and greater flexibility at the negotiating table, and ultimately a demonstrated willingness to accede to the UN Security Council’s demands for significant limitations to Iran’s nuclear program.

Sanctions and Nuclear Escalation

No data suggests that Iran’s nuclear program overall has slowed down over the course of the past four years. Iran’s stockpile of low enriched uranium (LEU) has grown from 839Kg in November 2008 to 8271kg in February 2013, according to the IAEA. Installed IR-1 centrifuges rose from 7100 in April 2009 to 12,669 by end of February 2013. Between November 2012 and February 2013, Iran also installed 180 of its more advanced IR-2m centrifuges. Moreover, Tehran began enriching uranium to 19.75% (MEU) in February 2010, and produced 280kg of MEU by February 2013 (of which over 100kg was turned into fuel plates for the Tehran Research Reactor.)

The growth of Iran’s nuclear program over the past four years has been steady and slightly escalatory. Juxtaposing the evolution of the nuclear program to the escalation of sanctions, the program appears at best entirely unaffected by the sanctions or at worst partly driven by the sanctions in the
sense that escalating sanctions as a bargaining chip also gives Iran the incentive to advance its program for the same reason. (See Graph 5.5)

The steady stream of biting – and at times strangulating – sanctions (or other pressure tools) imposed by the United States and its allies has neither reversed nor halted the growth of Iran’s nuclear program. From cyber attacks such as the Stuxnet virus – which did incapacitate a large number of Iran’s centrifuges – to travel sanctions, oil embargoes, and various banking and financial sanctions, the IAEA reports provide no evidence for these measures negatively affecting the progression of the Iranian program in a meaningful and measurable way. While these measures have not been inconsequential, they have not affected the trajectory of the nuclear program. And perhaps more importantly, these measures seem to have increased the Iranian government’s commitment to the program and reinforced the domestic political immunity it appears to enjoy.
Furthermore, elements within the Iranian government contend that the continuation and acceleration of the program has also been in response to sanctions. The (counter)-escalation has served several purposes. First, the Iranians say that they have deliberately doubled down on activities opposed by the West to convince the UN Security Council that the sanctions path is futile. “The mere continuation of the nuclear program shows that sanctions aren’t working,” an analyst connected to a government think tank in Tehran said. “Iran is willing to begin enriching uranium to 60-90% just to show that the sanctions don’t work,” a former Iranian nuclear negotiator added. Creating these new facts on the ground will also strengthen Iran’s future negotiation position, it is believed.  

According to this reasoning, the installment of new and more efficient centrifuges, combined with Tehran’s foot-dragging in response to the P5+1’s request for resumed talks, signaled Iran’s continued insistence on responding to pressure with pressure. The new IR2-m centrifuges can significantly reduce the time for any Iranian breakout option, and correspondingly, reduce the West’s ability to detect and react to such a breakout. “Iran still has several escalatory options, more options than the U.S. has,” an Iranian analyst with close ties to the Iranian National Security Council contended. “Iran can vastly expand the nuclear program, build more plants, add centrifuges, grow the stockpile, enrich beyond fifty percent etc. What additional sanctions can the U.S. impose?”

Second, Tehran counter-escalates by raising the cost for the West’s alleged refusal to deescalate the conflict. The expansion of the nuclear program brings Iran closer to a nuclear breakout capability, which in turn puts the West in a more compromised position. “Iran is under unprecedented sanctions, a barrage of physical sabotage, assassinations and cyber war,” the think tank analyst said. “Yet it still manages to not only continue its nuclear program but to expand it. Under these circumstances, its counter pressure is to continue its nuclear program. That is a huge achievement.” Other interviewees also echoed this sentiment.

Thirdly, Iran’s aim has been to compel the West to accept Iran’s right to enrich uranium. Former Iranian nuclear negotiator Ambassador Hossein Mousavian contends that Iran’s strategy is to respond to sanctions by escalating in such a way to convince the West that its aim is to solely gain recognition of its right to enrich uranium. “The nuclear program and the stockpile of enriched uranium have grown at a minimum speed,” according to Mousavian. “Iran could have added 10,000 new centrifuges a year if it wanted to. It deliberately chose a slower path to signal to the West that its aim is recognition for its right to enrich. Neither the stockpile nor the growing capacity were aims in and of themselves, but rather, measures to counter Western sanctions escalation.” According to the Iranians, the decision to turn a large part of its MEU stockpile into fuel pads was also aimed at signaling that Iran’s goal was not a nuclear bomb.

Yet, contrary to Tehran’s contention that it responds to pressure with pressure and that it still has several escalatory options at its disposal, there are question marks regarding Iran’s ability to truly actualize these options without bringing the stand-off to open warfare. From the Western perspective, Iran’s most egregious escalation prior to the installation of the IR2-m centrifuges was the operationalization of its Fordo underground facility and expansion of enrichment to 19.75%. These steps occurred prior to the most far-reaching Western escalatory measures.

The response from the Iranian side ranges from arguments that Iran does not need to escalate further since it currently can absorb the pain of the sanctions without compromising its nuclear activities, to the contention that Iran has instead escalated outside of the nuclear realm by providing Hamas with blueprints for longer range rockets (which came into use during the latest fighting between Israel and the Palestinians in Gaza), flying unmanned drones deep into Israel, and Khamenei raising the stakes in the Israeli-Iranian rivalry by declaring the entire globe the arena for their contest. “From now onward, we will support and help any nation, any group fighting against the Zionist regime across the world, and we are not afraid of declaring this,” Khamenei said on February 3, 2013. “This was a direct escalatory response to the pressure measures adopted by the West,” Mousavian argued. “Ayatollah Khamenei made this statement in response to both: US pressures, Israeli covert actions against Iran and repeating threats to attack Iran.” Interviewees on the Iranian side contend that it is at this stage premature for Iran to escalate beyond this point, arguing that the U.S. is wasting its cards by “playing them too fast.”

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26 Interview with foreign policy expert at government think tank, January 2013.
27 Thomas Erdrin, Khamenei: Iran will back ‘any nations, any groups’ fighting Israel, Washington Post, February 3, 2013. Interview with foreign
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While there was greater diplomatic activity in 2012 compared to 2011, there are no signs that sanctions have compelled Tehran to "come back to the table" in the manner that the sanctioning states desire. Three meetings between April and July 2012 failed to produce a compromise. Tehran signaled openness on halting enrichment at the 19.75% level, but resisted calls to cease activities at Fordo and ship out its stockpile of MEU. In return, Tehran sought lifting of sanctions and/or upfront recognition of its right to enrich – demands the U.S. and its allies rejected. Tehran dragged its feet in scheduling the fourth meeting, either seeking to create the perception that it is in no hurry, or truly believing that it could afford to play for time – or perhaps seeing little benefit in coming to the table. Either way, there are no signs yet that the sanctions noose around Tehran’s neck, in the words of State Department Spokesperson Victoria Nuland, has softened the Iranian negotiation position.

Some foreign policy hands in Tehran contend that in spite of increasingly uncontrollable infighting within the regime, viewpoints within various political factions have converged on the nuclear issue. Even influential foreign policy experts who were sidelined by Ahmadinejad and later joined the Moussavi campaign in 2009 believe that "succumbing under pressure only invites more pressure" and have even privately circulated proposals including measures such as a withdrawal from the NPT. Though Iranian officials no longer deny the immense impact of sanctions on the Iranian economy, Khamenei has remained steadfast and reinforced his political commitment of not letting sanctions affect Iran’s nuclear stance. Iran won’t negotiate "with a gun held to its head," he stated on February 7, in response to Vice President Joe Biden’s call for direct U.S.-Iran talks. In a speech on February 16, he expanded on his reasoning with a direct reference to sanctions and the notion that Tehran will react positively to incentives as opposed to pressure:

"Sanctions are painful and they are a nuisance, but there are two ways to react to such pain: One group are those who start begging for forgiveness, but a brave nation like Iran will try to mobilize its inner resources and to pass through the “danger zone” with determination and courage… The Americans should show that they don’t want to bully us, that they won’t engage in evil acts, show us that their words and deeds are not illogical and that they respect the rights of the Iranian people, show that they won’t push the region into further confrontations and that they won’t interfere in the internal affairs of the Iranian people – they will see that the Islamic Republic has good will and the people are logical. This is the only way to interact with the Islamic Republic."

The sanctions have, however, achieved one outcome: There is a more elevated and intense debate in Tehran not on the issue of talking to the U.S. directly, but rather on the issue of talking to America for the purpose of establishing a relationship with Washington. It is in this context that Khamenei’s statement is so critical, as he is rejecting the argument – not that Iran should establish relations with Washington – but that it should do so while facing escalating economic pressure orchestrated by the U.S. Khamenei is in essence declaring that the conversation about establishing relations with the U.S. (by first accepting the invitation for bilateral talks) will not translate into real action unless the sanctions approach first is retired.

Overall, sanctions have succeeded in putting tremendous pressure on the Iranian economy. The Iranian government’s response, however, has thus far not been to show greater flexibility, but rather to escalate matters further. Tehran has continued to expand its nuclear program and create new facts on the ground, it has sought to find ways to circumvent the sanctions rather than to acquiesce to them, and it has doubled down on the security mindset that empowers hardline security and intelligence communities – the very elements who benefit from a continuation of the crisis.

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Conclusion

This study demonstrates that there is a clear disconnect between the stated goals of the sanctions policy (a change in the Iranian calculus in regard to its nuclear program) and what sanctions have actually achieved.

Despite unprecedented economic pain inflicted on Iran since 2010, Tehran’s nuclear activities have continued apace — the stockpile of LEU has grown, new centrifuges have been added, MEU production has continued and as of 2013, Tehran has also begun installing advanced IR2-m centrifuges. The IAEA’s inspections of Iran’s nuclear sites reveal that the trajectory of the nuclear program is either unaffected by sanctions or partly driven by them. Tehran at times has escalated its program to gain bargaining chips in response to the presumed strengthening of the West’s negotiating position following the imposition of sanctions.

An argument in favor of the sanctions approach posits that the pressure of sanctions will not yield results in a linear manner. Tehran may be able to resist sanctions for an extended period of time, only to massively yield to the pressure after an inflection point has been reached. As such, judging the track record of sanctions thus far is inappropriate and misleading. This argument also reflects the political reality in which timelines and deadlines for sanctions are deemed unnecessary, whereas diplomatic efforts are judged more harshly and expected to yield extensive results almost instantaneously.1

However, even if the notion of a non-linear process is accepted, the factors that will cause an inflection point to emerge are known. These include the emergence of a narrative within the elite that challenges the status quo policy and incentives for regime stakeholders to press for a shift in policy. The existence of widespread discontent and anger against the regime does not equal pressure from society (or stakeholders) to shift the nuclear policy.

On these two crucial points, the study shows that the current approach has thus far failed to — and is unlikely to — produce an inflection point. The combination of suppressing open debates about the nuclear issue, the manner in which sanctions “vindicate” Ayatollah Khamenei’s narrative of Western animosity aimed at “defeating Iran,” and the absence of convincing and enticing incentives (such as proportionate sanctions relief) to change Iran’s nuclear policy has prevented the emergence of a potent counter-narrative within the Iranian elite. In the words of Roberto Toscano, Italy’s former ambassador to Iran:

“[P]ragmatic voices within the regime... should be capable of convincingly stressing that both national interest and regime survival would be better pursued by abandoning not only [Iran’s] provocative rhetoric but also its ideological intransigence. The problem is that this is made more difficult by sanctions, a godsend for those who are trying to rally Iranians around the regime and against external pressure.”2

Moreover, stakeholders in the system such as the business community have focused on seeking economic concessions from the regime rather than lobbying for a shift in Iran’s nuclear stance, according to our study. The absence of proportionate sanctions relief on the negotiating table appears to have prevented the emergence of incentives for the business community to forcefully challenge the regime’s nuclear strategy.

Successful cases in which enormous external pressure shifted the Islamic Republic’s policy on a central national security issue — such as Ayatollah Khomeini’s decision to “drink the cup of poison” and end the war with Iraq — included both a challenge to the dominant narrative and influential stakeholders pushing for a policy shift. In the case of the Iraq-Iran war, this was made


2 Email correspondence with Ambassador Roberto Toscano, February 19, 2013.
possible because it was clear to the Iranians that “drinking the poison” would unquestionably end the war with Iraq and they had confidence that Saddam Hussein could deliver on his end of the bargain. Tehran does not perceive a similar situation today, as two key issues remain unclear to the regime: what sanctions would be lifted if Iran were to succumb to Western pressure, and perhaps more importantly, whether the West has the political ability to deliver on sanctions relief.

A pressure strategy that lacks the sophistication and flexibility to help unravel the dominant narrative in the sanctioned state and entice stakeholders to push for policy changes is unlikely to succeed and potentially counter-productive. In the case of Iran, a continuation of the current approach will likely consolidate the anti-Western narrative and render a compromise more difficult.

The incentive structure as perceived by Iran’s leadership appears starkly different from what the U.S. and E.U. perceives. The latter believe sanctions have put Iran on a one-way path towards economic collapse unless it yields on the nuclear issue. Accepting the P5+1 proposal is a rational move, and rejecting it is either the result of miscalculation or ideological rigidity.

The former perceives a different reality. Khamenei’s behavior suggests he is aware of his regime’s unpopularity. Since 2009, the regime has lost several constituencies, rendering the few who support the regime and believe it to be legitimate all the more crucial. To these constituencies, the narrative of resistance against the West to uphold Iran’s independence is essential. Any move by the regime that will be perceived by this constituency as a capitulation to Western demands, i.e. a violation of the regime’s narrative, risks turning them against Khamenei. Mindful of Khamenei’s already weak support base, the loss of these last constituencies could be existential and prove a greater threat to the regime’s survival than even a military confrontation with the United States. While the regime does not hold out hope for actually winning war against the U.S., it certainly believes it can survive a war – and even come out of it stronger at home.

Consequently, it is highly unlikely that the regime will succumb to the sanctions pressure at a time when its narrative remains unchallenged within the elite, key stakeholders are not visibly lobbying for policy shifts, no proportionate sanctions relief is put on the table by the P5+1, and capitulation is seen as a greater threat to the regime’s survival than even a military confrontation with the United States.

Any calibration of the sanctions policy should focus on promoting a discourse that can undo the consolidated narrative that Western governments are opposed to Iran’s progress, and offer a solid prospect (such as proportionate sanctions relief) and clear arguments to Iranian stakeholders who have the ability to change the debate inside Iran. These measures can dramatically change the prospects of shifting Iran’s nuclear calculus.