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The United States and EU Can Still Avoid Conflict Over Iran Sanctions

By Joshua Kirschenbaum

By announcing the United States' withdrawal from the Iran nuclear deal and the full reimposition of nuclear-related sanctions on Iran, President Trump has backed European leaders into a corner. The EU is drawing up plans to defy the United States and continue to provide the economic benefits promised to Iran under the deal. Actual European moves to break the sanctions would do serious long-term damage to U.S. foreign policy and the transatlantic alliance.

However, the United States has room to maneuver under the flexible sanctions authorities, and there is still time to restart negotiations that would build on and strengthen the nuclear deal. In the ideal scenario, the United States parlays this act of brinksmanship into a diplomatic victory and takes credit for increasing the pressure on Iran without causing a rupture with European allies.

Hard Exit

The United States withdrew on May 8 from the Iran nuclear accord that it joined less than three years ago. Senior U.S. officials have called on America's European allies to capitulate to the reimposition of U.S. nuclear-related sanctions on Iran, the logic being that European companies cannot risk losing access to the U.S. market and therefore have no choice but to renege on promises they made to Iran. President Trump, who threatened "severe consequences" for anyone who continues sanctionable dealings with Iran, has pushed President Macron, Prime Minister May, Chancellor Merkel, and other heads of state into a corner. European leaders believe that the world is safer with Iran bound to the restrictions of the deal, which extended the window necessary for Iran to mount a nuclear breakout from weeks to approximately six months for a period of almost 15 years. To preserve their countries' independent foreign policies — and an autonomous global role for the European Union — the Europeans now have no choice but to stay in the deal and defy, or threaten to defy, the United States.

Fortunately, given the flexibility built into the nuclear-related sanctions and the often-fluid nature of President Trump's adherence to previously articulated foreign policy views, all is not lost. Europe and the United States can still work together over the next several months — when the most important nuclear-related sanctions come back into effect — to turn lemons into lemonade.

EU Reaction

Federica Mogherini, head of the External Action Service, which conducts foreign policy for the EU, met with the British, French, German, and Iranian (but not American) foreign ministers on May 15. Afterward, she announced that the European Union remains committed to the nuclear accord, officially known as the Joint Comprehensive Plan of Action, or JCPOA. By diplomatic standards, Mogherini's statement was acid:

"We recalled our commitment to the continued, full, and effective implementation of the Iran nuclear deal that was unanimously endorsed by the UN Security Council Resolution 2231, as a key element of the global nuclear non-proliferation architecture and a significant diplomatic achievement.

We, together, regretted the withdrawal of the United States from the Iran nuclear deal and we recognized that the lifting of nuclear-related sanctions and the normalization of trade and economic relations with Iran constitute essential parts of the agreement."

Mogherini and her team know U.S. sanctions authorities as well as anyone outside the U.S. government itself, having worked side-by-side with American sanctions experts for years, both during and after the nuclear negotiations. In her May 15 statement, she announced the EU's intention to find "practical solutions" to allow for the continued Iranian sale of oil, natural gas, and petrochemicals; ongoing foreign investment in Iran's energy sector; uninterrupted business between Iran and its trading partners more generally; and the necessary banking, financing, insurance, and shipping services to facilitate the above. In other words, Mogherini explained that the EU is planning to break U.S. "secondary sanctions," or sanctions that target third-country actors for dealings with Iran.[1] European Commission President Jean-Claude Juncker echoed Mogherini's remarks on May 18 and noted unanimous EU member state support for this approach. China and Russia will be happy to help.

EU Options

The sanctions relief that the Joint Comprehensive Plan of Action (JCPOA) provided to Iran fell into three main categories. First, the EU agreed to lift its prohibition on purchases of Iranian oil, petroleum products, petrochemicals, and natural gas. Second, the EU lifted restrictions on the development of Iran's energy sector. Third, the EU lifted banking and financial sanctions that inhibited all types of business, ranging widely from exports of advanced machinery to trade in any old widget.[2] In tandem, the United States lifted secondary sanctions on all three categories — oil and petrochemicals, energy sector development, and finance — so that third-country actors in Europe, Asia, or elsewhere engaged in such activity would not be at risk of penalty in the United States. With a few narrow exceptions,[3] the United States kept its broad embargo on Iran in place, covering trade, investment, and financial services.

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The removal of sanctions on oil sales is of the greatest economic importance to Iran in the near term. Those exports total over $50 billion per year, earning the country the lion's share of its hard currency reserves and funding a substantial portion of the government budget. Iran currently exports around $10 billion, or 20 percent of total exports, to the EU (primarily to Italy, France, Spain, and Greece) with 60 percent going to East and South Asia (China, India, South Korea, and Japan).

1 The phrase "secondary sanctions," while without legal meaning, is a policy term that refers to the systematic targeting of foreign actors who engage in certain categories of activity with the main subject of sanctions. Secondary sanctions are designed to ensure that the sanctions against the main subject are widely upheld and exert the maximum possible pressure. In the case of Iran, for example, European companies investing in a project to develop an Iranian oil field could lose access to U.S. government financing or contracts. The concept was developed in the 1990's, under the Helms-Burton Act (related to Cuba) and the Iran and Libya Sanctions Act, but was first applied with vigor in the period of intense sanctions pressure on Iran from 2011 to 2015. The United States discovered that the most effective secondary sanctions pressure point was the prospect of a cutoff in U.S. dollar access for foreign financial institutions that facilitated certain categories of sanctioned business, such as Iranian oil sales or transactions involving designated Iranian banks.

2 The highest-stakes item in the general commerce category is aviation, namely the sale of Airbus aircraft to Iran. Airbus planes use U.S. technology that is controlled by the Commerce Department, making Airbus's Iran business dependent on U.S. authorization.

3 The main carve-outs to the embargo that the U.S. agreed to as part of sanctions relief under the JCPOA include the authorization of U.S. aviation exports to Iran, authorization to import of Iranian foodstuffs, and the exemption of foreign subsidiaries of U.S. companies from the embargo. There are other exceptions to the embargo, but they predate the JCPOA.

The EU, in coordination with China, India, and Russia will explore the creation of a dedicated channel to facilitate oil purchases, possibly a shared banking, shipping, and insurance facility.[4] It is unlikely that Japan and South Korea would participate. It is true that major global commercial banks will not touch anything that could expose them to secondary sanctions, since they lack major financial interests in Iran and are dependent on access to the U.S. dollar. But the participation of a major commercial bank is unnecessary. European analysts are already calling for the involvement of state-run banks, including central banks. A state-owned bank, a central bank, or a willing private sector institution could take on the business. While the bank would risk losing U.S. dollar access, it would have a $50 billion book of business. The same goes for insurance and shipping. While players with a global presence will pass, a government-run insurance and shipping company, or private sector one without ties to the United States, could step up, particularly if there is clear government backing. The channel does not even need to be profitable if foreign policy considerations are paramount. A preview of this strategy can be found in the case of Bank of Kunlun, a small bank owned by the China National Petroleum Corporation, which was sanctioned in 2012 for activity sanctioned Iranian banks and then proceeded to conduct additional business with Iran, including the Quds Force, a designated terrorist group.

This scheme presents some obvious complications. Transferring funds to and from the bank of choice could be cumbersome and create potential sanctions exposure for banks on the other side of the transfer if not structured properly. Painstaking measures would need to be taken to wall off other parties from the sanctionable transactions. Entities involved in the shipment, storage, and refining of the oil would need to be carefully vetted to minimize sanctions exposure (if refiners balk, for instance, European governments may have to buy the oil from Iran and resell it domestically). But with a strong political and financial commitment from the EU, China, and Russia, such a project is viable.

The EU has also stated that it is committed to protecting European investment in and development of Iran's energy sector. Foreign capital and technology are critical to enable Iran to exploit new oil and gas fields, making this category of relief important in the longer term. While European imports of Iranian oil bounced back to pre-oil sanctions levels after the JCPOA went into effect, large-scale investment in Iran's energy sector has not yet materialized. The needs are vast (likely in the hundreds of billions of dollars), but banking, political, operational, and reputational hurdles have been a deterrent. The largest European entry into Iran's energy sector thus far is the agreement by Total of France to develop and operate Phase 11 of the South Pars, a natural-gas condensate field located in the Persian Gulf, as part of a $2 billion contract. Total has announced that it will pull out unless the United States promises not to target it with secondary sanctions, but it is likely that the outcome will be decided at high levels of the French and U.S. governments.

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It is far from clear what the United States would do if Total decided to move forward. Total is potentially exposed to the freezing of its assets in the United States, but penalties on energy companies in the past have traditionally been limited to far lighter measures. Furthermore, were the United States to impose severe sanctions on Total, the economic consequences for the French and global economies would be hard to predict. On top of that, the move would invite powerful retaliation by European governments against U.S. energy companies, who are equally exposed. Total may yet depart Iran, but it is not a foregone conclusion. The outcome of the Total fight would then inform the risk calculus of other energy firms around the world, such as Italy's Eni, moving forward. The likelihood that the EU can live up to its commitments to develop Iran's energy

4 Under the secondary sanctions on Iranian oil sales, banks risk losing U.S. correspondent account access for knowingly conducting a significant transaction for the purchase of oil from Iran unless the bank is located in a jurisdiction that the State Department has certified for significantly reducing its imports of Iranian oil over the previous 180-day period. Once the purchase has been made, the bank further risks exposure to secondary sanctions if it allows the proceeds to be used for any purpose other than either funding the export of domestic goods or services from the oil-importing country back to Iran or facilitating shipments of humanitarian goods (the latter not restricted to bilateral trade). These requirements were designed to reduce the absolute hard currency earnings of the Iranian government and to limit its access to those funds that it did accrue. If the EU and others decide to nominate a bank to become the central hub for Iranian oil sales and accept the possibility that it may be sanctioned by the United States, then there is no need to obey any of these requirements, and the bank can facilitate oil purchases by multiple countries and disburse the proceeds as Iran sees fit.

sector is lower than the likelihood that it can sustain its oil purchases, but it is possible. Again, Russian and Chinese firms are likely to be unconstrained on both accounts.

Under the third category of sanctions relief, general trade, it is likely that European banking channels would further narrow, making the trade more expensive and difficult. It is much less efficient to set up dedicated banking channels for hundreds of companies in all manner of industries than to set up a specialized channel for high-value oil sales and energy services work. Some larger-scale business could be diverted to the specialized oil channel. Nonetheless, non-energy related European trade with Iran would likely further decline, thereby diminishing the value of EU sanctions relief, making certain goods unavailable and potentially driving up consumer costs, although Asian and Middle Eastern firms could pick up some of the business.

The U.S. Should Play It Cool

The EU will prepare these plans in the hopes that a credible threat will force the United States to back down. That would be in everyone's best interest. Were the EU to implement these options, it would be a major foreign policy setback for the United States and a serious blow to the transatlantic alliance. The U.S. will have driven Europe into the arms of Russia and China, ceded the commanding political high ground to Iran, and potentially done long-term damage to the credibility of U.S. coercive diplomacy, with respect to economic sanctions and beyond. Should the U.S. government decide to retreat, there are three ways to do so, each of increasing elegance, none mutually exclusive.

The Amnesia Approach: In this approach, President Trump does not impose consequences on the Europeans and simply moves on to other topics. It is never optimal to fail to follow through when the gauntlet has been thrown, but it is superior to a U.S.–EU rupture.

The Aiken Option: Inspired by Senator George Aiken's suggestion during the Vietnam War that the United States declare victory and go home, in this option the United States imposes secondary sanctions of a purely symbolic nature against a limited targeted set. Were the EU to successfully ring-fence a dedicated channel for purchases of Iranian oil, sanctioning it may not have much of an economic ripple effect. Another variable is the flexibility built into the secondary sanctions authorities. The oil sanctions only apply if the president certifies that the global supply and price of petroleum are sufficient, providing an easy out.[5] Furthermore, banks facilitating oil sales need not be cut off from the dollar. Lighter, undefined penalties ("strict conditions") are available, although they have never been applied. As mentioned in the discussion of Total's participation in the South Pars field, the same flexibility applies to energy firms and other nonfinancial businesses. The White House can say that it delivered on its promise but allow the EU and others to continue providing the benefits promised to Iran under the JCPOA.

The Lemonade Scenario: Through some combination of declining to impose secondary sanctions on European companies and limiting any such sanctions to symbolic steps, the United States can declare itself "out of the deal," Iran can receive the benefits of the JCPOA, and the EU and United States can stay, if not aligned, then at least not in direct conflict. Such a scenario could even, if artfully managed, be conducive to effective diplomacy. Having upped the level of brinksmanship, the United States can restart the talks with the EU that the State Department conducted over the past months. The White House would have political cover to abstain from more damaging steps, explaining that withdrawal from the JCPOA gave it the leverage necessary to cajole the Europeans and coerce the Iranians to make additional concessions on ballistic missiles, access to military sites, and, possibly, extended sunset clauses.

Such an outcome will have been a risky, elaborate, and contorted trip back to where the United States was before May 8. If the Europeans are savvy and put emotion aside, they can keep the White House in the deal while allowing the White House to say, truthfully, that it got a better deal. President Rouhani's administration is now under political pressure to respond to the U.S. withdrawal. But the lemonade scenario stands the best chance of realization, of course, if Iran avoids provocative behavior, particularly with respect to the nuclear file. The whole experience will have been the

5 The basic concept of sanctionable oil sales is itself also amorphous, as jurisdictions are required to "significantly reduce" their purchases, but the numeric threshold for what constitutes a significant reduction is not set by statute.

wrong way to the right outcome, and preferable to the direction in which the transatlantic alliance currently seems headed.

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About the Author

Joshua Kirschenbaum is a senior fellow at GMF's Alliance for Securing Democracy, focusing on illicit finance.

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1744 R Street NW
Washington, DC 20009
T 1 202 683 2650 | F 1 202 265 1662 | E info@gmfus.org
http://www.gmfus.org/