THE WASHINGTON INSTITUTE for Near East Policy

PolicyWatch #1689

The East Asian Loophole in Iran Sanctions: Encouraging Compliance by Our Allies and China

By Christina Lin
August 12, 2010

Starting in August, U.S. officials are visiting East Asia, Latin America, and the United Arab Emirates (UAE) to garner support for tightening Iran sanctions under UN Security Council Resolution 1929. Robert Einhorn, the U.S. State Department's special advisor for nonproliferation and arms control, and Daniel Glaser, deputy assistant secretary of the treasury for terrorist financing and financial crime, started with a trip to Japan and South Korea and are planning a trip to China in late August. On July 29, the House Committee on Oversight and Government Reform held a hearing entitled "Implementation of Iran Sanctions" in which both Einhorn and Glaser expressed concern over China's compliance, with Einhorn emphasizing the "need for [China] not to 'backfill' when responsible countries have distanced themselves from Iran."

Mutual Dependence on Oil

East Asian countries are heavily dependent on crude oil imports from the Persian Gulf. Saudi Arabia is the largest provider, but Iran usually places second, ahead of the UAE, Kuwait, and Iraq. In early 2009, Iran was China's second-largest supplier after Saudi Arabia, though it is reported to have slipped to third place this year. In 2007, the Islamic Republic was Japan's third-largest supplier, after Saudi Arabia and the UAE.

Iran is similarly dependent on East Asia as a market for its crude. According to a June 18, 2010, Reuters report, the top Iranian petroleum export destinations in 2010 were Japan, at 502,000 barrels per day (b/d); China, at 440,000 b/d; India, at 330,000 b/d; and South Korea, at 190,000 b/d. With Iran's exports currently running at 2 million b/d -- down from 2.6 million b/d in 2008 -- Japan and China alone make up 47 percent of Iran's export market. If South Korea is included, East Asia constitutes 57 percent of this market.

Iran derives 80 percent of its export earnings solely from crude oil and its derivatives, and oil makes a similarly large contribution to government revenues. East Asian customers are, therefore, effectively underwriting a substantial portion of the Iranian regime's funds. Although UN sanctions on Iran do not ban oil exports, additional sanctions by the United States, the EU, and Canada have the effect of deterring crude oil purchases. By continuing to purchase oil from Iran, East Asian customers are providing a hedge for Tehran against these sanctions.

Currently, sanctions under Resolution 1929 target investment in the energy sector, access to financial systems, and shipping and air cargo companies; the sanctions also include visa bans on individuals, freezing of assets linked to the Iranian Revolutionary Guards Corps, and restrictions on trade insurance. They fail, however, to target the main lifelines of the Iranian regime -- the export of crude oil and import of refined petroleum to make up for shortfalls in domestic production of refined oil products, particularly gasoline. This latest round of sanctions, then, will likely have a limited effect on the regime and its behavior.

The Challenge of China

Much attention has focused on China's role in first blocking, and then watering down, tougher sanctions against Iran. China continues to advocate negotiation as the best way to settle doubts about Iran's nuclear program, and it has emerged as one of the major gasoline suppliers to Iran this year, replacing other fuel suppliers that have stopped sales for fear of U.S. retribution. The U.S. government has tried to exercise creative diplomacy to bring China into compliance with sanctions and to make it a "responsible stakeholder" in the international system. Bumpy bilateral relations in past years -- disputes over currency valuation, trade imbalances, and arms sales to Taiwan -- and difficulties in military relations have not helped this effort. However much Washington would like to see Iran as the number-one agenda item, Beijing, as always, continues to view its interests through the prism of the Taiwan issue.

By contrast, Japan and South Korea are U.S. allies, and thus the prospects for cooperation should be better. Although currently they have not implemented sanctions beyond Resolution 1929, it should be in their vital interest to do so; Iran and North Korea have joint missile programs and also possibly cooperate on nuclear weapons, which threatens East Asian and Middle Eastern regional stability. Iran finances North Korea's missile program in exchange for access to technologies; North Korea's Nodong missile series is the basis for Iran's flagship Shahab missile project. This means that Japanese and South Korean purchases of Iranian crude oil finance the North Korean weapons of mass destruction program that threatens them. The recent sinking of a South Korean naval vessel, the *Cheonan*, blamed on Pyongyang, has emphasized this issue.

Given Seoul's resolve to conduct joint military exercises with the United States in July, despite North Korea's threats of waging a nuclear war, and the positive atmospherics on the importance of the U.S.-South Korea and U.S.-Japan Alliance, this should have been an auspicious opportunity for the U.S. delegation to build solidarity on the issue of Iranian oil purchases. But the *Korea Times* reported on August 10 that Seoul was still not willing "to go after Iran . . . as hard as [the] U.S. wants." The article noted that Iran supplies about 10 percent of South Korea's oil and that bilateral trade was worth more than $16 billion. It added that the South Korean authorities have found evidence of wrongdoing at the Seoul branch of Bank Mellat, Iran's state commercial bank, but have yet to decide how and when to punish the bank. Tehran has responded angrily, with Vice President Muhammad Reza Rahimi saying in a speech, "The [South] Koreans . . . need to be slapped."

Iran is trying to secure new and improved energy relationships with East Asia. Last week, Iranian oil minister Massoud Mirkazemi flew to China seeking new investments in Iran's energy sector, including funding for new refineries. Another Iranian official said on July 3 that China was already investing $40 billion in Iran's oil and gas industry. China and Iran are reported to be exploring ways to sidestep sanctions by switching to non-U.S. and non-EU currency. An article in *China Daily* last month reported that Chinese oil company Sinopec has raised the idea of using Chinese yuan to settle trade by setting up a yuan account in a Chinese bank and receiving payments for crude sales that can be partly offset by Iran's purchases of Chinese fuels, equipment, and other projects. Iran is also said to be considering using the UAE dirham to settle accounts, but the yuan option is more realistic, given the size of Sino-Iranian trade -- $30 billion in 2010.

Incident in the Strait of Hormuz

The curious late-July incident in the Strait of Hormuz in which a Japanese tanker was damaged in what appears to have been a botched suicide attack may have increased Washington's diplomatic leverage. The tanker, now on its way to Japan, spent several days in a UAE port while investigators tried to ascertain what happened. The tentative conclusion appears to be that terrorists, linked to al-Qaeda and operating from Oman, rammed the vessel after it had transited the Strait of Hormuz, the relatively narrow exit of the Persian Gulf through which 20 percent of the world's oil -- representing 40 percent of internationally traded supplies -- passes daily.

U.S. forces, particularly the Bahrain-based Fifth Fleet, are crucial to deterring such attacks, as well as any threat posed to foreign shipping by Iranian naval and Revolutionary Guard units. Although Japanese and Chinese naval ships occasionally operate in the area, it is U.S. forces, working with regional allies, who ensure that shipping routes -- and East Asia's access to energy supplies -- remain open. In return, it seems reasonable to ask East Asia to choose other suppliers, especially given the spare capacity of current oil production, which has reduced the world's need for Iranian oil.

Christina Lin, a former director for China affairs at the Office of the Secretary of Defense, is a visiting fellow at The Washington Institute.