



## From Silk to Sanctions and Back Again: Contemporary Sino-Iranian Economic Relations

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### INTRODUCTION

Sino-Iranian economic ties have grown increasingly robust over the past 40 years despite efforts by the international community to strengthen the diplomatic and economic isolation of Iran vis-à-vis an ever-intensifying sanctions regime. As other nations retreat from their interactions with Iran, China benefits from consistent access to its oil and gas reserves in an environment of minimal international competition. Through this relationship, Iran finds a market for its vast oil and gas assets, as well as a partner through which to obtain support for infrastructure projects. It also benefits from importing China's refined gasoline for internal consumption, as Iran does not possess the internal capacity to produce refined petroleum in sufficient quantities to meet internal demand.

Despite this mutually beneficial framework for interaction, there are a number of challenges to the continued stability of Sino-Iranian economic ties. Iran's status as a pariah state within the international community presents China with a significant dilemma. China has grown highly reliant on its economic relationship with Iran; however, as a permanent member of the Security Council, it faces significant pressure to acquiesce to calls for strong sanctions, and suffers reputational costs as a result of its associations with Iran. Nevertheless, China continues to develop a broad network of economic partners,

thereby mitigating the negative impact on its economy should it come to find its relationship with Iran untenable. By contrast, Iran has considerably fewer options to replace the many functions served by China, and thus, a reduced economic relationship with China would likely spell disaster for Iran.

Looking forward, the Sino-Iranian economic relationship appears to be at an important crossroads. Numerous reports indicate progress on an overland pipeline network, a new "Silk Road", that would run through Iran and into China. However, China faces increasing risks and costs associated with its ongoing relationship with Iran. Completion of this new Silk Road therefore represents a critical fulcrum point in the pace, direction, and intensity of future bilateral ties.

This paper proceeds as follows. First, an in depth examination of the history and rapid growth of Sino-Iranian economic ties provides the contextual background necessary to understand the current state and future direction of the bilateral economic relationship. Next, the current status of the Sino-Iranian trade relationship is examined in greater depth, with a focus on energy exports and large-scale investment projects. The third section overviews the development of the international sanctions regime against Iran, and the strain that U.S., UN, and EU sanctions place on Sino-Iranian economic relations. Finally, the future of the Sino-Iranian economic relationship is examined through the lens of China's new "Silk Road" strategy, which seeks to connect China to the Middle East via overland road, rail, and pipeline routes.

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### A HISTORY OF SINO-IRANIAN ECONOMIC RELATIONS

Contemporary economic relations between Iran and China commenced shortly after establishment of diplomatic relations between the two countries in 1973, though commercial

interactions were initially quite limited. This period served as the basis for future strengthening of economic ties, which would grow from arms, to oil and gas, to large-scale infrastructure projects. In 1979, both nations underwent dramatic reforms that laid the foundation for their complex contemporary economic and political relationship. For Iran, the Islamic Revolution and subsequent hostage crisis reoriented the nation away from its strong ties to the West, setting the stage for economic sanctions and diplomatic isolation. Meanwhile, that same year, China implemented market based economic reform policies under Deng Xiaoping that led to rapid GDP growth and the emergence of China as a global economic force.<sup>1</sup>

During the 1980s, trade between the two nations primarily revolved around arms sales from China to Iran, which served to strengthen bilateral economic and military ties.<sup>2</sup> Trade between the two countries expanded rapidly during the decade, tripling from \$627 million in the early 1980s to \$1.7 billion by 1990.<sup>3</sup> This expansion of Sino-Iranian economic activity mirrored the rapid growth of the Chinese economy, which experienced on average 9.6 percent annual growth between 1980 and 1993,<sup>4</sup> bringing the economy from a position of near collapse

prior to the implementation of Deng's economic liberalization policy in 1979, to a position of relative strength by the early 1990s. By contrast, Iran's post revolution economy came exceedingly under state control, and its \$644 billion<sup>5</sup> war with Iraq led to negative rates of real economic growth, declining oil production and revenue, and high inflation.<sup>6</sup>

As China's economy grew, so too did its energy demand, and in 1993, China crossed the threshold from net oil exporter to net oil importer.<sup>7</sup> Additionally, both nations found themselves increasingly at odds with the United States and the West in the early 1990s, as China grappled with issues surrounding human rights and Taiwan, while U.S. sanctions resulting from Iran's nuclear aspirations began to strangle the Iranian economy, significantly restricting trade partners and limiting sorely-needed investment in Iran's depleted post war infrastructure. These measures forced Iran to further orient its economy eastward at the same time that China began seeking external sources for its rapidly growing energy demand. It was under these conditions that Iran and China began to expand their economic relationship from arms sales to energy,

and beyond. With each round of sanctions, China has continued to further exploit the opportunity to secure energy resources from Iran in an environment of decreasing international competition,<sup>8</sup> while strengthening its power projection capabilities in geo-strategically significant Iran.

Today, the Sino-Iranian economic relationship is highly robust. China threatens to overtake the European Union as Iran's largest trading partner, and is already Iran's largest foreign investor, with over 100 companies operating within the Islamic Republic.<sup>9</sup> Oil and gas play heavily into the bilateral relationship, and the non-energy portion of the relationship has expanded significantly in recent years to include a wide range of sectors such as industrial goods and infrastructure development.<sup>10</sup> Looking forward, China appears to be developing a new "Silk Road" strategy, in which Iran would figure prominently as an important node on overland road, rail, and pipeline routes designed to facilitate increased cross-continental trade.<sup>11</sup>

Though all signs point to continued expansion of the Sino-Iranian economic relationship, there are indications of increasing friction. First, Iran's business environment is challenging. The combination of unpredictable pricing and contractual terms that often come with political strings attached threatens to push Chinese and other international investors away from Iran.<sup>12</sup> Observers believe that the difficulty of doing business with the Iranian regime might influence China to shift towards Saudi Arabia for its energy needs.<sup>13</sup> The ever-intensifying sanctions regime further exacerbates this issue, as foreign firms must weigh the benefits of doing business in Iran against the risk of U.S. sanctions or being barred from bidding on U.S. contracts.<sup>14</sup> Furthermore, China expends a great deal of political capital through its dealings with Iran, complicating its interactions with the United States and its role on the Security Council.

With China's growth largely driven by globalization and a strong economic relationship with the West, its association with Iran has the potential to become too great a liability to maintain. While China has gone to great lengths to dilute the severity of Security Council sanctions on Iran<sup>15</sup> – thereby protecting its beneficial trade relationship – Iran's global pariah status gives rise to the conclusion that its relationship with China is asymmetrical. It is clear that Iran needs China more than China needs Iran.<sup>16</sup> Thus, Iran is at a significant politico-economic crossroads. With increasingly proactive sanctions driving an ever-expanding wedge between Iran and the West, the regime's economic relationship with China is an existential necessity. Mutual dependencies will undoubtedly assure that the Sino-Iranian

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relationship is maintained, if not inflated, in the short term. However, as China continues to integrate into the global political economy, it might ultimately come to find its relationship with Tehran untenable.

## TRADE & INVESTMENT

During the course of the past 20 years, the Sino-Iranian economic relationship has experienced rapid expansion. Between 1994 and 2009, bilateral trade grew from \$400 million<sup>17</sup> to over \$21 billion,<sup>18</sup> with China representing Iran's third largest import partner, largest export partner, and second largest trade partner overall. Chinese investment in Iran is also on the rise. The Sino-Iranian economic relationship is centered on the energy sector, but the non-energy portion of the relationship has also experienced significant growth in recent years.

Iran holds the world's third largest source of proven oil reserves and second largest source of proven gas reserves.<sup>19</sup> Naturally, the Iranian economy revolves primarily around the energy sector, and this is the basis of Sino-Iranian economic ties. In 2009, Iran supplied China with more than 23 million metric tons of crude oil, making it China's third largest supplier after Saudi Arabia and Angola.<sup>20</sup> Iran is also China's largest source of liquefied petroleum gas. It is important to note, however, that Sino-Iranian energy trade is not exclusively unidirectional. Due to the lack of internal refining capabilities, Iran imports 40 percent of its refined gasoline from external sources,<sup>21</sup> of which China provided 30 percent in 2009.<sup>22</sup>

As a result of the Iran-Iraq War and the imposition of sanctions, Iranian energy sector infrastructure has become outdated and inefficient. China plays a large role in rebuilding this infrastructure as well as engaging in joint venture exploration and oil and gas field development projects.<sup>23</sup> Between 2005 and 2010, Chinese firms signed contracts worth \$120 billion in the Iranian energy sector.<sup>24</sup> However, due to the challenges and potential political backlash associated with doing business in Iran, these "commitments" are generally in the form of non-binding memoranda of understanding, which are easily revocable in the event of political, economic, or internal instability.<sup>25</sup> Recent investment projects of note include a \$40 billion deal to revamp Iran's petroleum refining industry in 2010, a \$2 billion Sinopec Group contract to develop the Yadavaran oilfield in southwestern Iran in 2007, and an agreement between Beijing and Tehran for an additional \$70 billion in

assistance dedicated towards development of the Yadavaran oil field in exchange for ten million tons of liquefied natural gas from Iran.<sup>26</sup>

Sino-Iranian commercial relations outside of the energy sector are also quite strong. China imported \$3.12 billion of Iranian non-energy goods in 2009,<sup>27</sup> and has also made extensive non-energy related infrastructure investments in Iran, including construction contracts for bridges, highways, railways, airport infrastructure, and metro rail systems.<sup>28</sup> Additionally, it is reported that China has expressed interest in assisting with the development of Iran's other extractive industries including titanium, aluminum, copper, and coal.<sup>29</sup> China also exports manufactured goods to Iran such as computer systems, household appliances, and cars.<sup>30</sup>

The regulatory infrastructure surrounding the Sino-Iranian economic relationship still has considerable room for improvement. Iran has yet to sign a customs agreement with Iran, and the two countries have yet to coordinate their import export regulations. Additionally, financial and banking obstacles remain, and

there is a distinct need for the establishment of a legal arbitration board for bilateral disagreements.<sup>31</sup>

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## SANCTIONS

Since the Iranian Revolution in 1979, Iran's relationship with the United States, Europe, and the West has grown increasingly combustible over issues such as WMDs and terrorist sponsorship. With Iran's every step towards 'rogue state' status, the United States, European Union, and United Nations have responded with increasingly proactive sanctions that attempt to target the economic and political pillars of support for the Islamist regime and further isolate Iran from the West. China, meanwhile, has not hesitated to profit from the economic void left by the torrent of Western economic outflow.

### U.S. Sanctions

Dating back to the Iran hostage crisis, the United States has taken the lead in implementing the most extensive and expansive sanctions on Iran to date, and urged the rest of the international community to follow suit. In response to the Iranian takeover of the U.S. embassy in Tehran in November 1979, President Carter issued a series of proclamations and executive orders to freeze Iranian assets domiciled in the United States, and ban exports to and imports from the Islamic Republic. Carter lifted

the import/export ban at the conclusion of the crisis, but these measures set the stage for the increasingly proactive sanctions regimes that followed.<sup>32</sup>

Following the bombing of the U.S. embassy and marine barracks in Lebanon in 1983 – which the United States claimed Iran played a key role in funding and planning – Ronald Reagan declared Iran a state sponsor of international terrorism in 1984. In October 1987, Reagan instituted a ban on U.S. imports of Iranian crude oil and other products, citing Iran's continued support of international terrorism and belligerent action against U.S. flagged vessels and merchant ships in the Persian Gulf during the Iran-Iraq War.<sup>33</sup>

Iran's development of WMD capabilities emerged as an issue of national concern in 1992 when the United States signed into law the Iran-Iraq Arms Proliferation Act, which limited exports of dual use items to Iran. Iran's widely documented nuclear ambitions, coupled with pressure from American pro-Israel groups, led to the passage of the Iran-Libya Sanctions Act (later shortened to the Iran Sanctions Act, or ISA) in 1996.

The ISA provides the United States with the authority to sanction all foreign parties found to have invested more than \$20 million per year in the Iranian oil sector or to have sold weapons of mass destruction (WMD) technology to Iran.<sup>34</sup> The goal of the ISA is to deny Iran the financial resources required to sustain its WMD ambitions and support for terrorist groups by limiting the development of its energy sector, and the strategic rents that result from its vast energy production capabilities. However, implementation has proven difficult, and the sanctions were largely toothless in practice, lying dormant between 1997 and the legislative strengthening of the ISA in 2010.<sup>35</sup>

Despite these enforcement problems, between the ban on U.S. investment in Iran and the imbedded fear of non-instrumental consequences resulting from violation of the ISA, the United States succeeded in pushing many Western firms to ratchet back Iranian energy investment projects. However, the inability of the United States to effectively impose sanctions under the ISA gave China confidence that it could continue to intensify economic interaction with Iran without subjecting itself or its private sector firms to punitive action.<sup>36</sup> As a result, since the inception of the ISA, China has committed billions of dollars to projects aimed at modernizing and expanding Iranian energy production capacity.<sup>37</sup>

In July 2010, the Comprehensive Iran Sanctions, Accountability, and Divestment Act (CISADA) enhanced and strengthened the ISA, making investigation of violations mandatory,

and providing an exemption mechanism for violators that pledge to end their business operations in Iran.<sup>38</sup> The CISADA legislation led to the first successful implementation of sanctions under the ISA on Swiss based oil trading firm, Naftiran Intertrade Company, as well as later actions against five major energy sector investing companies.

The effectiveness of the CISADA legislation indicates an increasing coalescence of international opinion on Iran. Despite this, China appears unconcerned and undeterred by CISADA and the now proven ability of the United States to successfully implement ISA sanctions. As of March 2010, the U.S. Government Accountability Office (GAO) identified three Chinese firms – China National Offshore Oil Corporation, China National Petroleum Corporation, and Sinopec – publically reported to have commercial activity in the Iranian energy sector.<sup>39</sup> To date, ISA sanctions have not been imposed on these companies, nor have these firms indicated any intention of scaling back their Iranian operations. It is clear that while the rest of the world continues to retreat from Iran, U.S. sanctions have proven ineffectual in their ability to modify the behavior of China and its private sector.

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#### United Nations Sanctions

The United Nations Security Council has enacted four rounds of increasingly proactive sanctions on Iran under Chapter VII of the UN Charter. China's role as a permanent member of the Security Council with veto power complicates passage of sanctions resolutions pertaining to Iran, and forces China to walk a fine line, balancing protection of its economic interests in Iran against its reputation in the international community. It is significant to note that although China opposes sanctions in principal, and does its best to reduce the severity of sanctions during negotiations, it has not yet used its veto to actually strike down sanctions legislation. China's begrudging acquiescence in the Security Council demonstrates that while it certainly values its economic relationship with Iran, this is not at the expense of its relationship and reputational considerations with the West.

The UN sanctions regime dates back to the passage of resolution 1696 in July 2006, which gave Iran a deadline of August 31, 2006 to "suspend all enrichment-related and reprocessing activities, including research and development,"

threatening coercive economic and diplomatic sanctions if it did not comply.<sup>40</sup> The only dissenting vote came from Qatar, with China and Russia – much to the dismay of Iran – failing to veto or even abstain. In December 2006, after finding that Iran had not satisfied the conditions laid out in resolution 1969, the Security Council adopted resolution 1737, which blocked the import and export of nuclear materials and equipment and imposed travel restrictions and asset freezes on individuals and entities engaged in Iran's nuclear weapons program.<sup>41</sup>

Having again failed to curtail Iran's development of nuclear capabilities, the Security Council passed resolution 1747 in March 2007, which broadened the scope of resolution 1737. During the negotiations surrounding passage of this resolution, the Chinese were instrumental in watering down the financial measures initially proposed in the draft resolution, with the final resolution stating that the sanctions should "not affect normal economic, trade and financial exchanges between Iran and other countries."<sup>42</sup> Thus, China succeeded in appearing to stand in solidarity with the international community, while protecting its trade relationship with Iran.

After significant political wrangling with China in June 2010, including U.S. warnings of "economic insecurity and diplomatic isolation" if they failed to pass the new sanctions regime,<sup>43</sup> the Security Council passed resolution 1929, which further broadened the scope of previous Security Council resolutions and included far more proactive means of economic sanction, including prohibition of transactions with Iranian banks that facilitate proliferation activities and additions to the list of entities subject to asset freezes.<sup>44</sup>

Significantly, resolution 1929 notes the potential link between Iran's energy sector revenues, energy related technologies, and proliferation.<sup>45</sup> Establishing this nexus between Iran's energy sector and its proliferation activities provided justification under international law for individual countries to impose energy sanctions, thus adding weight to the ISA and similar unilateral sanctions imposed by the EU, Canada, Japan, and others.<sup>46</sup> Not surprisingly, China and Russia again took the lead in watering down the sanctions, ensuring that they did not explicitly target financial transactions or energy sector interactions.<sup>47</sup> Nevertheless, the gradual evolution of the UN sanctions from 2006 to the present suggests an increasing coalescence of international opinion, and, correspondingly,

increased political vulnerability for China as a result of their relationship with Iran.

### European Union Sanctions

Over the last 15 years, antagonism between the European Union and the United States regarding Iran sanctions policy has slowly evolved towards a state of mutual agreement. In sharp contrast to the political and legal disputes over early implementation of the ISA, in July 2010 the EU imposed new punitive sanctions measures that aligned its policy with that of the United States, and exceeded the minimum mandatory regulations imposed by the UN. Included in the new measures are a ban on new investments in Iran's oil and gas industry, prohibitions against the transfer of technology and technical expertise, restrictions on the IRGC, and limitations on the Iranian financial sector.<sup>48</sup> As

a result, China is soon expected to overtake the EU as Iran's largest trading partner.

It is difficult to gauge the net effect of this attitudinal and policy shift on the Sino-Iranian economic relationship. From the perspective of Iran, this shift further limits their economic options and heightens its economic reliance on China. For China, the accelerated exodus of EU money out of Iran will undoubtedly create additional opportunity for China, but the EU move towards stricter regulation places further attention on China as an enabler of the Iranian regime, thus representing a political liability for China.

### CONCLUSION: A NEW SILK ROAD?

As the Sino-Iranian economic relationship continues to expand, reports indicate that China may be setting its sights on a new Silk Road strategy designed to connect China to the Middle East via overland road, rail, and pipeline routes.<sup>49</sup> Such a strategy would allow China to further leverage its robust economic relationship with Iran, which sits in a strategic position at the center of the energy rich MENA region, with access to the Arabian Sea, Indian Ocean, and Caspian Sea. Overland gas pipelines would figure prominently into this strategy,<sup>50</sup> and allow China to consolidate its soft power in the region for significant geopolitical and economic gain.

There are two major components to this new Silk Road strategy. First, the proposed Iran-Pakistan natural gas pipeline would serve as an interconnection between Iran and Turkmenistan, which would then connect to China.<sup>51</sup> However, this project has encountered significant obstacles

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as a result of U.S. opposition to the project and terrorist activities within Pakistan aimed at scaring away potential investors.<sup>52</sup> Furthermore, it is difficult to determine the exact route of the pipeline and the role that China would play. Though the initial plans targeted India as the terminal location of the pipeline, China – at Iran’s invitation – has come to play a pivotal role in the construction and planning of the pipeline, and may now be in a position to usurp India’s role in project.

The second component of the strategy is the North-South corridor project, which would create a road and rail link between China and Iran via Afghanistan, Tajikistan, and Uzbekistan.<sup>53</sup> This plan is highly ambitious and subject to significant changes in implementation and routing. Geographically, Iran represents the most direct route between the Middle East and East Asia, and therefore, the ongoing willingness of the Chinese to work with the Iranian regime is a necessary component of this strategy.

If successful, China’s new Silk Road threatens to further complicate international attempts to compel Iranian nuclear compliance and is likely to further intensify the fissure over the Iranian issue within the Security Council. Construction of supply and transportation routes through Iran will add a physical dimension to Sino-Iranian commercial ties, calcifying the existing, but still tenuous, economic relationship through significant infrastructure investment. In this sense, the Silk Road strategy represents an implicit commitment to future strengthening of

Sino-Iranian economic ties. As mutual economic interdependence grows, China will take on the unenviable challenge of balancing its commercial relationship with Iran against growing cries for strong sanctions by the international community.

The future of Sino-Iranian economic relations is a critical fulcrum point for the Iranian regime. Should China follow through on its new Silk Road strategy, Iran’s leaders will continue to receive the oil rents necessary to prop up their regime and fund nuclear development initiatives. However, if the United States and the rest of the international community can successfully compel China to decrease its support for Iran, decreased oil rents will likely allow revolutionary elements such as the Green Movement to take on a position of increasing strength within Iranian domestic politics, and threaten the political status quo. As the outlook and policies of the international community coalesce, both the political costs and economic benefits associated with China’s economic involvement in Iran continue to grow. It seems clear that at some point these tensions will reach a head, and one force will topple the other. China’s ability to implement its new Silk Road strategy will likely play a pivotal role in determining which of these forces will prevail.

*The views and opinions expressed in articles are strictly the author’s own, and do not necessarily represent those of Al Nakhlah, its Advisory and Editorial Boards, or the Program for Southwest Asia and Islamic Civilization (SWAIC) at The Fletcher School.*

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