Ratcheting Up Economic Pressure on Iran II

Mohsin S. Khan explains how sanctions on Iran's central bank could lead to difficulties for Iran's imports and an effective embargo on its oil exports.

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Steve Weisman: The pressure from the West on Iran over its nuclear program is taking many forms. There are reports of sabotage and assassinations of those involved in the nuclear program. Treasury Secretary Geithner is trying to persuade China and other countries not to buy oil from Iran. There's escalating tension in the Strait of Hormuz. But today with Mohsin Khan, senior fellow at the Peterson Institute, I want to talk about the new sanctions threatened over Iran's Central Bank. This is Steve Weisman. Mohsin, there's been new legislation that would bar transactions with Iran's Central Bank. How would that put pressure on Iran?

Mohsin Khan: That is of course the latest evidence of pressure on Iran about its development of its nuclear facilities. There are two things that have happened. One is the proposal to have an oil embargo, which we can discuss. On the Central Bank itself, that seems to be a big thing happening because it makes it very difficult for Iran to be able to export. I mean, it's another form of embargoing their exports. But more significantly, it also puts severe restrictions on Iran's ability to import. And the way it works, Steve, is that people who buy Iranian products—principally oil, of course—have to have a mechanism whereby they pay Iran. And how do they pay Iran? Restrictions on several major banks have been in place for a while now, for a couple of years. In order for payments to be executed, they have to go through the Central Bank. Physically, that's a problem for Iran. People who are buying Iranian products cannot find a mechanism to pay Iran for the products they buy.

Steve Weisman: Let's say you're a customer. You would deposit your payment in first maybe a Western bank that would then make the payment to the Iranian Central Bank. Are there ways of circumventing this?

Mohsin Khan: There are ways of circumventing this, but it makes the transaction costs higher. In principle, you're right. What happens is that a customer of Iran would in fact be paying Iran through either a Western bank or through an Iranian bank and then it would go to the Central Bank. However, since Iranian banks have had a lot of problems and foreign banks are reluctant to work with Iran because of US regulations, what has been happening is that customers have been paying directly to the Central Bank through their own bank. So they draw a check on their own bank and then they transfer the funds to the Central Bank.

Steve Weisman: What I don't understand, how can the US prevent that? I mean, it's a sovereign country or company in another country making a payment to another sovereign entity, the Central Bank of Iran. How can the US bar that from happening?

Mohsin Khan: No, it can't actually bar that from happening. What the US has done is that banks that transact with Iran will not be able to transact with the US. And that's the way the restriction works. If a bank abroad chooses not to worry about that, they can go ahead. There is nothing United States can do to prevent that. However, the United States has said that, "Look, if you're a bank and you transact with the Central Bank of Iran, you cannot transact with any financial institution in the United States."

Steve Weisman: This has worked in Europe. The Europeans have said they're not going to in effect buy Iranian oil recently. But can this be applied to banks in other parts of the world that depend on Iranian oil without having repercussions that might blow back to the United States?

Mohsin Khan: That's what I was trying to say at the beginning. You have to look at this in two parts. One is an oil embargo which says, "We won't buy oil from Iran," and the Europeans have said that. The United States buys very little oil from Iran anyway, but the United States has said that. That's the direct restriction on buying oil. The second, related one is the Central Bank restriction.

Steve Weisman: But it's seeking to accomplish the same objective?

Mohsin Khan: The same goal. The same objective.

Steve Weisman: Who are the big oil customers for Iran?

Mohsin Khan: The biggest oil customer is China. China buys roughly twenty-five percent of Iran's oil.

Steve Weisman: India also?

Mohsin Khan: Yes. China is the largest, Japan is the second largest, followed by India, South Korea, and so on.

Steve Weisman: But these are countries that the US is trying to work with on so many other matters. Japan and Korea are close allies. How is this going down with them?

Mohsin Khan: Well, Steve, it's in the news. It's going down OK according to the headlines today in Japan, with Secretary Geithner being able to persuade the Japanese, who said that they would reduce the amount of oil they buy from Iran. It didn't go down at all well in China. China said that this is a completely separate issue. All the purchases are completely separate from the nuclear issue. So it's not clear what the Chinese would do. It's not clear what the Indians would do. As long as there are buyers in the market somewhere, it doesn't affect the Iranians. Of course the discount on Iranian oil becomes larger. It does because it's more complicated. Let's take a specific example. The Europeans decide that they don't want to buy any more oil from Iran, but they have to buy oil from somewhere. So what they would do presumably is go to Saudi Arabia, which is the only country which has excess capacity. And they would say to the Saudis that, "We'll buy X million barrels a day from you now, which we were buying previously from Iran."

Steve Weisman: Are the Saudis increasing production to accommodate that?

Mohsin Khan: They have the ability to, particularly if—this is a complicated situation – if Libya comes on line, which it is coming slowly, but surely. If it comes back on line, remember that the Saudis decided to compensate for the loss of Libyan oil production. They could do the same and move and sell more oil. They couldn't increase production so much, so the Saudis would reduce the amount of oil they sell to China and transfer that to Europe. The Asians, in turn, would then buy more oil from Iran.

Steve Weisman: But we want them to buy less.

Mohsin Khan: That's correct. As long as the Asians are not willing to go ahead with the oil embargo, the oil embargo will not work. That's the bottom line.

Steve Weisman: The dollar is the currency with which oil is traded, but the dollar is the world's reserve currency. Is there any way that throwing around the weight of the status of the dollar as a reserve currency could backfire on the US and cause countries to say the "US is overreaching with its ability to exercise leverage," causing people to go to other currencies, which we might not like?

Mohsin Khan: True, but I think that at the moment, the US is totally fixed on this issue of the nuclear facilities in Iran. In many ways and it's doing whatever it can. You can say that the Europeans are on board with the United States. The problem is, can you persuade China and India and South Korea to go along with you? And if you recall, on most sort of sanctions, whether it be Iran or Syria or wherever, China and India, etc., have been very reluctant to go along with the sanctions.

Steve Weisman: What effect is this having on Iran's economy?

Mohsin Khan: I think this is bound to have an effect on Iran's economy. That's why I don't think that what you mentioned about the Iranians closing off the Strait of Hormuz is at all really likely. I mean, this is just, in my view, saber rattling and posturing because Iran has so much to lose. If the Straits of Hormuz were cut off even for a short period of time -- and there are discussions as to whether they can be -- the fact of the matter is that one can honestly say everyone loses. Because Iran loses its oil, everyone loses, and the oil market will go wild in that. Let's say in the case of the United States, which is not importing that much oil from there and in fact, could substitute other sources of oil, including from its strategic petroleum reserve -- but the fact is that oil prices will go through the roof and that will have a major impact on the world.

Steve Weisman: But Iran's economy?

Mohsin Khan: Iran's economy is suffering now, I think. Sanctions are making transaction costs high. We were talking about the impact on oil exports. Now, remember that the revenue from exports of oil go to the government. On the other hand, it's having a major impact on imports and imports are done primarily by the private sector. So the scramble for dollars has started.

Steve Weisman: So prices must be going up in Iran.

Mohsin Khan: Prices are going up in Iran. Furthermore, the exchange rate is slipping very rapidly.

Steve Weisman: Which also raises the price of imports.

Mohsin Khan: Exactly, which raises the price of imports. On the sanctions against the Central Bank, we only talked about the export side. It also has a major impact on the import side. If people are finding it very difficult to import things, to get letters of credit opened, because they were opening them through the Central Bank which then dealt with the foreign financial institution. So that if I'm importing Italian goods and I'm an Iranian, I go to the Central Bank and the Central Bank arranges for the funding so that I can pay the Italian bank through a Central Bank transfer. Now if there are sanctions and the Italian Central Bank cannot transact anymore with the Central Bank, it won't accept payment. So I can't import. So that's having an impact already, but I expect [it will] during the next few months, if this continues, if in fact the sanctions go into effect.

Mind you, the sanctions aren't in effect right now. They will be in six months. Then there's a waiver and so on. The US administration can use a waiver. But I just hope that this is posturing and saber rattling. And to some extent, Steve, I'll say that that's the way the markets are viewing it. And one particular market that I watch is the oil market and the oil market hasn't really shown any kind of sense that the Straits of Hormuz will be closed or that the sanctions will push the price of oil up. But in fact, I'll go further and say: I don't think that the oil markets believe that this oil embargo is going to be successful because the prices haven't moved.

Steve Weisman: Thanks, Mohsin.

Mohsin Khan: My pleasure. Thank you, Steve.