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# Middle East Brief

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## The Impact of Sanctions on Iran-GCC Economic Relations

Nader Habibi

In June 2010 the United Nations approved a fourth round of sanctions against Iran, and a few weeks later several nations announced additional unilateral measures. There is now strong evidence to suggest that despite repeated denials by some Iranian leaders, these sanctions are imposing a heavy cost on the Iranian economy. Some of Iran's major trade partners, such as South Korea, are among the latest countries to have introduced unilateral trade sanctions against Iran. During the past two decades, imposition of the sanctions has evolved into a dynamic game between Iran and the United States: Every new round of sanctions by the U.S. or the international community has provoked a series of countermeasures by the Iranian government intended to neutralize them. The impact of this back-and-forth has become highly visible in the economic relations between Iran and the six member countries of the Gulf Cooperation Council, or GCC (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates [UAE]).

In the past, GCC countries often exhibited a lukewarm attitude both toward international economic sanctions and with respect to possible military action against Iran's nuclear program. While reluctantly going along with the UN-approved international sanctions (though the record varies from country to country), GCC countries generally refused to cooperate with unilateral U.S. sanctions. It now appears, however, that since January 2010 some GCC countries, particularly Saudi Arabia, have become more vocal in expressing their

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concerns about Iran's nuclear program and have offered greater cooperation with U.S. efforts to contain it.

The growing cooperation of GCC countries with U.S. policies to isolate Iran economically represents a major setback in Iran's economic and diplomatic efforts to improve its ties with GCC countries at the expense of the United States over the last ten years. Economic diplomacy was an important pillar of Iran's policy toward GCC countries during this period.<sup>1</sup> By increasing its volume of trade and investment with GCC countries, Iran was hoping to enhance its value to these countries as an economic partner. And aside from this deliberate policy, Iran was also forced to rely more on trade with GCC countries—the UAE in particular—as a result of the escalating sanctions. The difficulties that sanctions caused for Iran in trading with Europe and even with some Asian countries forced Iran to rely more and more on re-export opportunities vis-à-vis its Southern neighbors.

This Brief offers an overview of Iran's economic ties with its GCC neighbors since 1980 and of how these relations have been affected by United States sanctions against Iran. It reviews first diplomatic and then economic relations between GCC countries and Iran after the 1979 Islamic Revolution and then considers the impact of the multiple rounds of anti-Iran economic sanctions on Iran-GCC relations.

## Iran-GCC Diplomatic Relations

With the exception of Saudi Arabia and Oman, the members of the GCC are relatively young states. Kuwait gained independence from the United Kingdom in 1961; Bahrain, Qatar, and the United Arab Emirates were established in 1971 after several decades of domination by the United Kingdom. During the 1970s the Shah of Iran acted as the gendarme of the Persian Gulf with the military and political support of the United States. The GCC states reluctantly accepted the dominant role of Iran, but at the same time they received direct military protection and diplomatic support from the United States and the United Kingdom. This arrangement came to an end with the overthrow of the Shah and the emergence of the Islamic Republic of Iran.

Overall, post-1979 relations between Iran and the GCC countries can be divided into three distinct phases. The first period, from 1980 to 1989 was dominated by mutual hostility and distrust. While Iran's interference in the domestic affairs of these countries was initially ideologically motivated, it assumed a strategic dimension during the second half of the Iran-Iraq war as Iran sought to eliminate GCC support for Iraq by fomenting religious uprisings and instigating regime change.

Soon after returning to Iran from exile and establishing a new government, Ayatollah Khomeini questioned the legitimacy of the ruling families of the neighboring Arab sheikdoms and openly called for replacing these regimes with Islamic governments. This militant attitude deteriorated the relatively cordial relations that the countries that would unite to form the GCC had developed with Iran in the 1970s. The rulers of these countries felt threatened by the open hostility of Iran's Islamic regime and responded with three distinct policies. They closed ranks and created the Gulf Cooperation Council in 1981 as a security pact against the perceived threats from Iran (and, to a lesser extent, from Iraq). They intensified their security and military alliances with the United States. And they offered sizeable financial support to Iraq during the 1980–88 Iran-Iraq war.

The death of Ayatollah Khomeini in 1989 and the ascent of Ali Akbar Hashemi Rafsanjani as Iran's new president resulted in a pragmatic change in Iran's Middle East policy and launched the second phase of Iran-GCC relations, extending from 1989 to 1997. Under President Rafsanjani, Iran abandoned its "regime change" objectives vis-à-vis the GCC countries and focused instead, during the first years of Mr. Rafsanjani's presidency, on improving diplomatic relations with its Arab neighbors, with the strategic objective of encouraging the GCC countries to abandon their security arrangements with the United States and enter instead into a regional security alliance with Iran.

This objective proved unattainable, however. Still skeptical of Iran's motives, the GCC countries remained committed to their military alliances with the United States.<sup>2</sup> Iraq's invasion of Kuwait in 1990, which was defeated by U.S.-led international forces, strengthened U.S.-GCC relations, much to Iran's displeasure. Nevertheless, although it maintained neutrality during this war, Iran opposed the Iraqi occupation of Kuwait, and this posture provided an opportunity for a partial improvement in Iran-GCC relations. Iran and Saudi Arabia restored diplomatic relations in 1991, though those relations remained relatively cold during the remaining years of Mr. Rafsanjani's presidency. Iran maintained independent diplomatic relations with the other, smaller GCC countries, but these relations were often influenced by the state of Saudi-Iran relations.

The third phase of Iran-GCC relations began in 1997 when Iran hosted the annual meeting of the Organization of the Islamic Conference (OIC) only a few months after the inauguration of President Mohammad Khatami. Hosting the conference increased the legitimacy of the Islamic government of Iran among Muslim nations and paved the way for a further improvement of relations between Iran and Arab countries.<sup>3</sup> Better relations with Iran were also partly due to the rising power of Crown Prince Abdullah, who had been serving as the de facto leader of Saudi Arabia since 1995 and was interested in strengthening Saudi Arabia's regional ties. Former Iranian president Rafsanjani visited Saudi Arabia in 1998, and this visit—the first high-ranking Iranian visit to the Saudi kingdom since the 1979 revolution—led to a further warming of relations. Saudi Arabia also encouraged other GCC countries to improve their ties with Iran.

The expansion of diplomatic and economic ties between Iran and Saudi Arabia during the third phase was more substantial than before and included several diplomatic visits. One important area of cooperation pertained to crude oil policy within OPEC. Saudi Arabia and Iran were both suffering from the low price of oil in the mid-1990s (when prices fell below \$10 per barrel in some months). Improved relations allowed for better coordination of OPEC

production quotas, which eventually led to higher oil prices after 1999. Another benefit of improved Iran-Saudi relations was the resumption in September 1997 of direct flights between Tehran and Jeddah for the first time in eighteen years.

Iran's relations with other GCC members have also improved in recent years, but they remain sensitive to specific bilateral concerns. Among GCC countries, Oman and Qatar have maintained the warmest diplomatic relations with Iran since the 1979 revolution; both countries sought normal and cordial relations with Iran despite being close allies of the United States. By contrast, Bahrain's ruling regime has had a tense relationship with Iran on account of its own ethnic mix. While the ruling regime belongs to the Sunni sect, Shiites constitute the majority of the population, and the ruling al-Khalifa family, which maintains close ties with the United States and Great Britain, is concerned about Iran's influence among Bahraini Shiites. Furthermore, until the late eighteenth century Bahrain was periodically under Iranian rule before it became a British protectorate<sup>4</sup>. After Iran's Islamic Revolution, some Shiite clerics in Bahrain called for the creation of an Islamic government, but their political aspirations have been frustrated by the al-Khalifa ruling family. In recent months the government of Bahrain has arrested many Shiite activists and revoked the citizenship of a prominent Shiite clergy, Ayatollah Hossein Mirza Nejati, but Iran has maintained a neutral stance and refrained from offering any formal support for the political struggle of Bahraini Shiites.

Iran has a minor territorial dispute with Kuwait and a more serious dispute with the United Arab Emirates. The Iran-Kuwait dispute revolves around an offshore gas field called Arash by Iran and al-Durra by Kuwaitis.<sup>5</sup> The field is claimed by both nations, and in recent years Iran has tried to resolve the dispute by calling for its joint development. Iran-Kuwait relations deteriorated after the Islamic Revolution, but in recent years both countries have taken positive steps to improve their diplomatic and economic ties.

Iran and the UAE have an unresolved dispute over three small islands in the Persian Gulf. Iran occupied the islands of Abu Musa, Greater Tunb, and Smaller Tunb in November 1971, a month before the British withdrawal from the Persian Gulf and the creation of the UAE as an independent nation. At that point the emirate of Sharjah claimed sovereignty over Abu Musa, while the emirate of Raas-al-Kheimah claimed the Tunb islands. As Sharjah and Raas-al-Kheimah became part of the UAE, the islands dispute evolved into an Iran-UAE dispute that is yet to be resolved.<sup>6</sup>

In spite of this dispute, Iran and the UAE have maintained diplomatic relations in the past three decades, and the UAE has emerged as one of Iran's largest trade partners—a seeming contradiction that is explained, perhaps, by



the long history of trade and travel between Iran and the northern emirates of Sharjah, Raas-al-Kheimah, and Dubai. The emirate of Dubai, in particular, is home to an estimated 400,000 residents of Iranian descent. The al-Maktoum ruling family of Dubai has always maintained warm relations with Iran and has welcomed several waves of Iranian immigrants beginning in the early twentieth century, when conservative Iranian merchants who were opposed to Reza Shah's forced unveiling of women migrated to Dubai. These first immigrants are now predominantly Arabized and are well integrated within commercial and political circles in Dubai. The latest wave of immigrants consists of merchants and professionals who moved to Dubai after the Islamic Revolution in search of economic opportunities and cultural freedom. They play an important role in bilateral trade and investment between Iran and the UAE.

Iran's interest in warmer relations with GCC countries has continued through Mahmoud Ahmadinejad's presidency, which began in 2005. While repeatedly making controversial statements against Israel and expanding Iran's support for militant Islamic groups such as Hezbollah and Hamas, Ahmadinejad has exhibited a moderate and cooperative attitude toward the GCC states; he has also visited several GCC capitals in recent years. Continuity with respect to Iran's new policy toward the GCC has been maintained by the Supreme Leader, Ayatollah Khamenei, who plays a dominant role in setting foreign policy and whose constitutional powers are very broad. The hostile international environment and ongoing tensions with the United States have also compelled Iran to improve its economic and diplomatic ties with its wealthy Arab neighbors.

At the same time that direct bilateral relations between Iran and the GCC were improving in the past decade, Iran and Saudi Arabia were becoming more competitive in their attempt to influence the course of events in the rest of the Middle East. With the fall of Saddam Hussein and the empowerment of Shiites in Iraq, Saudi Arabia became concerned about the rising influence of Iran and its Shiite allies in the Arab world. The Saudis actively supported Sunni ethnic groups during Iraq's sectarian civil war after 2003 and encouraged the United States to insist on constitutional rights for Sunnis in Iraq's post-Saddam political structure.

Saudi Arabia and Iran are also locked in fierce competition over Lebanon's factional politics. To counter Iran's support for Hezbollah, Saudi Arabia has backed the Sunni and Christian factions. The competition in Lebanon, however, has assumed some constructive dimensions in recent years. Iran and Saudi Arabia used their influence over Lebanese political factions to mediate a political settlement after the 2006 Lebanon-Israel war.<sup>7</sup>

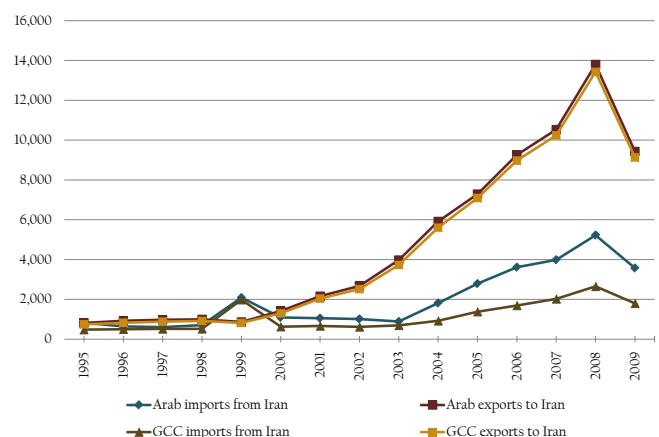
## Economic Relations

Both Iran and the GCC countries trade more with developed countries than with each other or with other developing countries. As oil-exporting countries they have similar economic needs, and few export products that they can offer one another; their main import products are industrial products, machinery, and capital goods, which they obtain, for the most part, from developed industrial countries. As a result, the volume of bilateral trade between Iran and the GCC has historically represented only a small share of each side's total trade.

In the past, Iran's exports to its Arab neighbors consisted primarily of agricultural products and handicrafts. More recently, GCC countries have expressed an interest in purchasing natural gas from Iran for residential consumption and as feedstock for their growing petrochemical industries. In the past decade, both Iran and the GCC countries have made advances in low-tech and intermediate manufacturing, resulting in a moderate amount of trade in manufactured and industrial products between them—mainly in petrochemical products and light consumer goods.

Until the year 2000, the volume of trade between Iran and the GCC countries was very limited. As shown in Figure 1, the volume of Iran's imports from and exports to the GCC was less than one billion dollars in most years. Thereafter, GCC exports to Iran enjoyed dramatic growth, from \$1.3 billion in 2000 to \$13.4 billion in 2008. Iran's exports to GCC countries also increased, but at a slower pace—from \$630 million in 2000 to \$2.62 billion in 2008. As a result, the GCC countries have enjoyed a sizeable trade surplus with respect to Iran, which reached a peak of \$10.7 billion in 2008 and decreased to \$7.3 billion in 2009.

**Figure 1. Iran-Arab Trade as Reported by Arab Countries**  
(in millions of dollars)



Source: International Monetary Fund, Direction of Trade Statistics, June 2010.

The sharp increase in Iran's imports from GCC countries was not evenly distributed among GCC members. As shown in Table 1, the United Arab Emirates has dominated GCC exports to Iran, followed by Saudi Arabia as a distant second. Thus, in 2008 the UAE exported \$13.2 billion to Iran, while aggregate exports of the other five GCC members were only \$1.58 billion. Table 1 also reveals that while Iran's trade with GCC countries has enjoyed exceptional growth since 2000. Iran's imports from the UAE rose 11 times during 2000-2008 while imports from other GCC members grew 14 fold.

In light of the unresolved islands dispute, it seems paradoxical that the UAE has emerged as one of Iran's largest trade partners. As I will explain in later sections, however, the complex international dynamics of the UAE federation are the main factor that has led to this seemingly unlikely situation. What sets the UAE apart from other GCC countries is the port city of Dubai, which serves as a major re-export center for the entire Middle East and particularly for Iran. Most of Iran's imports from the UAE either originate in Dubai or arrive in Dubai for re-export to Iran. Some products are re-exported to Iran after some minor assembly and repackaging in Dubai. The UAE Ministry of Foreign Trade has estimated the value of re-exports to Iran at \$7 billion in 2009, reflecting a 16% increase compared with 2008.<sup>8</sup>

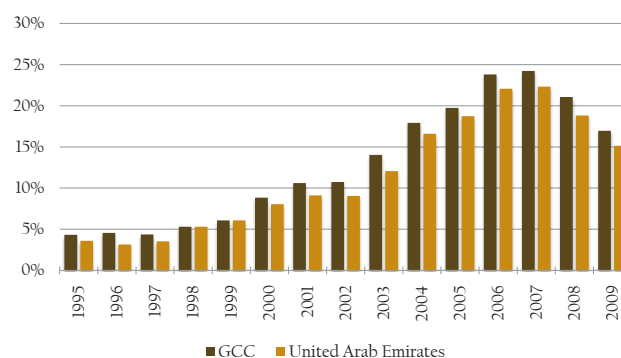
**Table 1. Iran's Imports from GCC Countries**  
(in millions of dollars)

Year	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
1995	60	5	3	1	21	441
1996	129	4	1	5	77	473
1997	59	15	0	2	55	562
1998	0	0	0	0	0	759
1999	0	0	0	0	0	769
2000	24	8	2	4	74	1,154
2001	65	10	4	5	163	1,502
2002	52	11	2	20	261	1,848
2003	55	25	4	23	405	3,135
2004	42	80	6	66	249	5,476
2005	50	64	3	27	254	7,285
2006	101	107	22	31	444	8,980
2007	112	175	51	58	469	10,081
2008	147	229	509	76	615	13,199
2009	100	155	346	52	418	8,973

Source: International Monetary Fund, Direction of Trade Statistics, June 2010, Trade data as reported by the Islamic Republic of Iran to the IMF.

The dominant position of the UAE in GCC exports to Iran is also evident in Figure 2. The UAE is almost singlehandedly responsible for the rapid increase in the GCC's share of total imports from Iran in the period 1995–2008. This share rose from less than 5% in 1995 to 24% in 2007, nearly all of the increase accounted for by the UAE. The UAE's share in GCC imports from Iran, however, is less dominant. Although Iran has consistently exported more to the UAE than to any other GCC member, the UAE share has gradually diminished, from 59% in 2002 to 41% after 2005, as shown in Table 2.

**Figure 2. Share of GCC in Iran's Total Imports of Goods**



Source: International Monetary Fund, Direction of Trade Statistics, June, 2010

Since 2004, Saudi Arabia has emerged as the second largest GCC importer from Iran. Saudi imports, which remained well below \$100 million annually until 2000, grew to \$900 million in 2008 before experiencing a sharp decline in 2009. But unlike Iran-UAE trade, which has resulted in a huge trade surplus for the UAE, Iran-Saudi trade has been relatively more balanced; indeed, in recent years Iran has enjoyed a trade surplus (see Figure 3). Furthermore, despite the steady increase in the volume of bilateral trade between the two countries, the relative share of Iran and Saudi Arabia in each other's foreign trade remains small. As a result, it seems unlikely that trade and economic considerations will serve as a major determining factor with respect to diplomatic relations between the two countries.

**Table 2. Iran's Exports to GCC countries**  
(in millions of dollars)

Year	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE
1995	18	83	31	22	60	269
1996	15	66	29	23	59	308
1997	4	61	33	16	66	338
1998	17	73	24	18	66	325
1999	0	103	40	22	76	1,742
2000	0	134	61	23	98	315
2001	0	130	46	25	119	348
2002	0	123	22	19	90	365
2003	0	137	46	18	115	381
2004	0	157	41	14	274	438
2005	0	209	53	52	487	582
2006	0	250	112	53	583	697
2007	0	295	157	63	688	822
2008	0	386	208	82	901	1,076
2009	0	262	141	56	612	731

Year	GCC Total	Saudi Share	UAE Share
1995	481	12%	56%
1996	500	12%	62%
1997	518	13%	65%
1998	522	13%	62%
1999	1,983	4%	88%
2000	631	16%	50%
2001	668	18%	52%
2002	619	15%	59%
2003	696	17%	55%
2004	924	30%	47%
2005	1,382	35%	42%
2006	1,694	34%	41%
2007	2,024	34%	41%
2008	2,652	34%	41%
2009	1,803	34%	41%

Source: International Monetary Fund, Direction of Trade Statistics, June 2010. Trade data as reported by GCC Countries to the IMF.

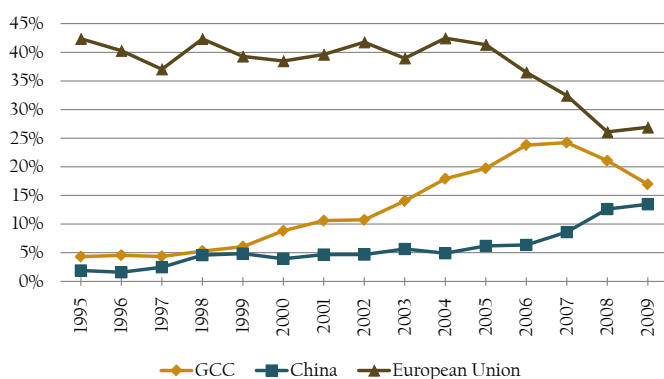
**Figure 3. Iran-Saudi Trade as Reported by Saudi Arabia**  
(in millions of dollars)



Source: International Monetary Fund, Direction of Trade Statistics, June 2010

In order to assess the relative significance of Iran-GCC trade, Figure 4 shows the relative shares of Europe, China, and the GCC in Iran's goods imports. As can be seen, the GCC's share of Iran's total imports grew steadily between 1998 and 2007, while European countries' shares remained relatively stable. China has emerged as one of Iran's leading trade partners in recent years; Figure 4 shows that its share began to increase after 2004. The increase in China's share after that year is associated with the decline in the European Union's share. Overall it is clear that in recent years Iran's imports' origins have shifted from other regions to China and the GCC. As will be explained in the next section, both increasing international sanctions and strategic considerations have played important roles in this reorientation of Iran's trade patterns.

**Figure 4. Shares of Major Trade Partners in Iran's Total Imports**



Source: International Monetary Fund, Direction of Trade Statistics, June 2010

## The Sanctions' Impact

The economic and financial sanctions that the international community has imposed on Iran, with various degrees of intensity for more than two decades, have had two distinct impacts on Iran's foreign trade. First, the uneven participation of various nations in these sanctions forced Iran to shift its trade from countries that had joined in the sanctions to others. Germany was Iran's largest trade

partner in the 1990s, for example, but the sanctions have had an adverse effect on Iran-German trade in recent years. In 1990 Germany accounted for 14.4% of Iran's imports, but its share gradually declined to 11.4% in 2007 and 8.9% in 2008. The increasing difficulties entailed in trading and conducting financial transactions with Germany and other European countries after 2006 have forced many Iranian firms to look for other sources of needed imports.<sup>9</sup> As a result, Iran has expanded its imports and exports with some Asian countries, at Europe's expense.

Second, Iran has used trade and investment incentives to discourage some countries from joining in the sanctions. This proactive "trade diplomacy" was applied with respect to Europe in the 1990s when the Iranian government deliberately expanded its trade and investment ties with Germany, France, Italy, and the UK to increase the costs to them of joining the U.S.-sponsored sanctions initiatives. These economic incentives in turn contributed to the strong preference on the part of the Europeans for settling the nuclear dispute through negotiation. In recent years Iran has offered even stronger economic and trade incentives to Russia and China for the same purpose.

Both of the aforementioned factors have influenced Iran-GCC economic relations since 1995. In the earlier phases of the U.S. sanctions against Iran the restrictions applied primarily to U.S. corporations and their international subsidiaries, and because of its long history of trade with the U.S. before the 1979 revolution, Iran was in need of some U.S.-made spare parts and electronic products that were subject to sanctions. Iran was forced to obtain these products in the black market or to purchase them indirectly through intermediaries. The liberal trade policies and free trade zones of Dubai offered Iran a valuable opportunity to procure sanctioned goods, such as popular computers and software, through Dubai re-exporting arrangements. It is noteworthy that the sanctioned products represented only a portion of Iran's total imports from Dubai; ordinary consumer goods and nonsensitive products were also commonly traded via Dubai.

The ease of travel to, and investment opportunities in, the UAE (mostly in Dubai) has allowed many Iranian business entities to establish branches there; in 2008, as many as 9,500 businesses in the UAE were partly or completely owned by Iranians. The largest concentration of these firms is found in the Jebel Ali free trade zone. (One hundred percent foreign ownership is allowed only in free trade zones; outside them, foreign partners can own only up to 49% of an enterprise.) These firms have played an important role in facilitating trade and investment relations between Dubai and Iran.<sup>10</sup> The large number of Iranian tourists who visit the UAE have also contributed to enhanced trade relations. There are on average 300 commercial flights per week between the two countries.<sup>11</sup>

Overall, the adverse impact of sanctions on Iran's direct trade with its traditional trade partners is responsible for the reorientation of Iran's trade toward the UAE in recent years. The growth in Iran-Oman trade volume is also partly due to the sanctions. Iranian firms that faced difficulties and long regulatory delays in direct dealings with Europe were able to avoid these difficulties by setting up UAE-based firms that were not identified as Iranian entities. These firms not only facilitated indirect imports from other countries to Iran via Dubai; they also allowed some Iranian producers to export their products and services to foreign partners who would have been reluctant to deal with Iranian firms. This practice has been particularly popular with some Iranian software companies.

Iran's growing trade and economic reliance on Dubai in response to the European sanctions has not gone unnoticed by the United States. In recent years the U.S. has urged the UAE government and financial institutions that operate there to reduce their ties with Iranian entities. Despite its islands dispute with Iran, the UAE federal government has been reluctant to go beyond the UN-sponsored sanctions by cooperating with unilateral U.S. sanctions. This reluctance is on account of the economic benefits that accrue to the emirate of Dubai from its widespread trade and investment relations with Iran.<sup>12</sup>

In 2008, however, the United States began to pressure UAE-based financial firms to cut back on their trade finance services for Iranian businesses, by warning that violators would lose access to the U.S. market. Several financial institutions that are concerned about their business interests in the United States have voluntarily complied with this demand—and mounting evidence ever since suggests that their actions have had an adverse effect on Iran's trade relations with Dubai and with the rest of the UAE. The government of the UAE, on the other hand, like other GCC governments, has been reluctant to openly support the unilateral U.S. sanctions but has been willing to comply with UN-approved sanctions against Iran. Accordingly, it responded swiftly to the latest round of UN sanctions that were approved in June 2010. Only a few days after UN approval of these sanctions, the UAE Central Bank ordered its banks to freeze the assets of forty-one Iranian entities in compliance with the new sanctions.<sup>13</sup>

Iran's concerns about the sanctions also partly explain the growth in Iran-Saudi trade volume during 2001-8. As part of its efforts to improve its diplomatic relations with Saudi Arabia and discourage the Saudi government from siding with the United States, Iran sought to expand its trade and investment ties with the kingdom. This strategic consideration was visible in the middle years of Mohammad Khatami's presidency (1998-2004), when Iran's imports from Saudi Arabia grew by some 315%, to \$274 million. The upward trend continued during Ahmadinejad's presidency,



with Iran's imports from Saudi Arabia rising to a record \$901 million in 2008. In addition, Iran made a strong effort to promote bilateral investment vis-à-vis Saudi Arabia, and in 1998 the two countries signed a comprehensive cooperation agreement which had a strong economic dimension. During this period the Saudis generally advocated a negotiated settlement of the Iran-U.S. nuclear dispute, and on occasion it tried to help improve U.S.-Iran relations.

Economic relations between Iran and Saudi Arabia continued to expand during President Ahmadinejad's first term, and Saudi Arabia continued to publicly express skepticism with regard to sanctions and about the wisdom of a military strike against Iran's nuclear installations. But the Saudi position has shifted away from Iran and closer to the United States since 2009. Angered by Ahmadinejad's militant Middle East policy and concerned about the apparent progress of Iran's nuclear program, in recent months Saudi Arabia has cooperated more closely with U.S. sanctions initiatives.

It also appears that along with Saudi Arabia, the UAE and other, smaller GCC countries are also showing a greater willingness to support U.S. sanctions, which are more restrictive than the UN sanctions. Thus, the Kuwaiti oil trader IPG ended its gasoline sales to Iran in January 2010 in response to warnings from the United States.<sup>14</sup> In early July 2010 an Iranian official claimed that Kuwait had joined the UAE and Germany in refusing to supply jet fuel to Iranian commercial airplanes, but this claim was later denied by the Iranian government.<sup>15</sup>

As was mentioned earlier, there has been a disconnect between the UAE's diplomatic and economic relations with Iran which requires explanation. This disparity is primarily due to disagreements between the ruling families of Dubai and Abu Dhabi with regard to Iran. Dubai, which benefits heavily from trade and investment ties with Iran, attempted to downplay the islands dispute and to discourage the UAE federal government from joining in the U.S. sanctions. The Abu Dhabi ruling family, by contrast, is less friendly toward Iran and more willing to side with the United States. Since the UAE constitution gives each emirate considerable independence in its conduct of economic and trade policy, Dubai has expanded its economic ties with Iran. Yet at the same time the occasional tensions between the UAE federal government (which is dominated by Abu Dhabi) and Iran have continued, and the islands dispute has remained unresolved.

The recent shift away from Iran in the attitude of the UAE is partly a result of the diminishing relative economic and financial power of Dubai within the broader UAE framework. Dubai's economy suffered a major setback in 2009 when the real estate market collapsed and the

government-owned conglomerate Dubai World failed to repay its debt obligations in November of that year, forcing Dubai to turn to the wealthy emirate of Abu Dhabi for financial assistance. This economic setback reduced Dubai's political power within the federal government of the UAE, enabling the Abu Dhabi ruling family to distance the UAE from Iran and increase its cooperation with the U.S. sanctions in 2010.

In addition to directly cooperating with the UN sanctions, some GCC countries have played an important role in helping the United States persuade China to cooperate with the efforts to apply effective sanctions against Iran. During several rounds of intense diplomatic efforts in the first half of 2010, the U.S. asked Saudi Arabia and the UAE to offer additional oil sale assurance to China and encourage it to join in the latest round of UN-sponsored sanctions, which was approved in June 2010. While there have been no formal declarations, it appears that these GCC countries have complied with this U.S. request, and their promise to supply more oil to China in case of disruptions in its imports from Iran has played an important role in convincing China to support the June 2010 UN sanctions. Iran accounted for 11% of China's crude oil imports in 2009, but the volume of imports in the first half of 2010 was smaller than in the first half of 2009. During the same period, China's crude oil purchases from Saudi Arabia, Brazil, and Angola increased.<sup>16</sup> Saudi Arabia supplied 14% of China's crude oil imports in 2009.

Overall it appears that Iran's various initiatives to discourage the GCC from joining in the U.S.- and UN-sponsored sanctions, while successful in the past, have failed in recent months. In addition to Dubai's declining influence on UAE foreign policy, two other factors have contributed to this failure. First, in order to deter GCC cooperation with military operations against Iran, the Ahmadinejad government has taken a "carrot-and-stick" approach toward the GCC states. On the one hand, Iran is trying to improve economic and diplomatic ties with its GCC neighbors. On the other hand, in the past two years Iranian military leaders have repeatedly warned that, if attacked, they will retaliate by closing the Strait of Hormuz and by targeting countries that host U.S. forces or provide logistical support to the U.S. Army. This threat was primarily meant to increase the cost to the United States of an attack against Iran, but it was also directed at GCC countries that might offer logistical support for such an attack. This frequently repeated Iranian threat resulted in a development that Iran did not intend: Worried, the GCC governments sought closer security cooperation with the United States.

Second, the success of Iran's uranium enrichment program in the past two years has taken GCC countries by surprise and has convinced them that Iran might be closer



to developing a nuclear weapons capability than they expected—and this fear contributed to their willingness to offer greater cooperation with anti-Iran sanctions. In June and July of 2010, the official and semi-official Iranian media sharply criticized Saudi Arabia and the UAE for cooperating with these sanctions.

It must be added, however, that for most GCC states the tilt toward the United States will likely remain limited, and they will try to maintain a posture of neutrality if possible. While they have shown a willingness to comply with UN sanctions, they are likely to cooperate only cautiously with the unilateral sanctions applied by Europe or the United States, in order to avoid further complications in their relations with Iran.

## Sanctions and Smuggling

Along with the formal trade between Iran and GCC countries, a large volume of goods are exchanged between Iran and two GCC countries—the UAE and Oman—through smuggling. Most of the smuggled goods are shipped from the GCC region to Iran. Smugglers use small boats to transport commodities from Dubai and from the small Omani enclave of Madha at the southern shores of the Strait of Hormuz. For a small boat it is only a few hours' ride from Dubai to Iran's shores on the northern edge of the Persian Gulf. The boat ride from the small port city of Khasab in the Omani territory to the Iranian island of Qeshm takes only fifty minutes, and some smugglers are even able to make two such trips per night.<sup>17</sup> While most of the products that are smuggled into Iran from these areas are low-tech consumer goods with no strategic value, the same routes are also used to transport small-size strategic goods such as aircraft parts, computer chips, and sophisticated electronic equipment that can be carried on small boats.<sup>18</sup>

Profit-motivated smuggling between Iran and GCC countries is not a new phenomenon; local smugglers have transported goods in both directions for centuries. The recent economic and commercial sanctions against Iran, however, have added a new dimension to this practice. The sanctions have forced Iran to smuggle in some strategic goods that it can no longer purchase on open markets. Not surprisingly, the government of Iran has supported these smuggling activities by establishing front companies (primarily in the UAE) and providing logistical support for the navigation of smuggling boats in Iranian waters.

In 2002, Mehdi Karrubi, then Speaker of the Iranian parliament who is currently one of the main opposition leaders in Iran, claimed that the Revolutionary Guards (IRGC) were actively involved in smuggling operations. According to one of his aides, the Guards had built some sixty jetties on the southern shores of Iran and on the

islands of Kish and Qeshm to facilitate their clandestine imports. This claim has been more recently confirmed by Mohsen Sazegara, a founder of the IRGC, who currently lives in exile in the United States.<sup>19</sup> The jetties allow the IRGC to smuggle large volumes of goods into Iran for both commercial and strategic purposes.

The smuggling of goods from Dubai and other GCC areas to Iran has caught the attention of U.S. officials, who are now likely to put additional pressure on the UAE government to limit such activities. However, since most of the smuggling is carried out by small boats and often at night it will be very difficult for the UAE government to completely end these operations.

A sizeable volume of goods is also smuggled across the Iran-Iraq border. Most of this smuggling, which has been going on for decades, takes place in the mountainous Kurdish regions with the participation of Kurdish villagers on both sides of the border. Since June 2010, when both U.S. and European sanctions focused more intensely on Iran's gasoline imports, Kurdish smugglers have been busy transporting refined oil products to Iran.<sup>20</sup>

At the same time, as a result of Iraq's liberal trade policies since 2004 the volume of trade between Iraq and the UAE has sharply increased—exceeding \$5 billion in 2009, when Iraq became the UAE's second largest Arab trading partner.<sup>21</sup> If direct smuggling of products from Dubai to Iran becomes more difficult, it is likely that some smugglers will first send their products legally from Dubai to Iraq and then smuggle them through various land routes into Iran.

The Islamic government of Iran maintains good relations with the regional government of Kurdistan (in Iraq) as well as with many Shiite factions in southern and central regions of Iraq. Consequently it will not be very difficult for Iran to set up a Dubai-Iraq-Iran smuggling network. In response to the escalating sanctions, the Iranian smugglers have already established transport networks in several neighboring countries, including Turkey.<sup>22</sup>

If the current sanctions continue and become more comprehensive, the volume of goods smuggled into Iran is bound to increase (as long as Iran's oil exports and oil revenues are not targeted for sanctions). The Dubai-Iran and Dubai-Iraq-Iran smuggling routes, in particular, are likely to see a sharp increase in the volume of transported goods.

One factor that is likely to facilitate this smuggling activity is the favorable opinion of a large segment of people in most Arab countries toward Iran. The 2010 Arab Public Opinion Poll, conducted by Shibley Telhami of the University of Maryland and Zogby International, is revealing. Conducted in June and July 2010 in six Arab countries including Saudi Arabia and the UAE, the survey shows that 77% of

the respondents believed that Iran had a right to develop its nuclear program. Even among the Saudi and UAE respondents who believed that Iran was seeking nuclear weapons, 50% and 16%, respectively, believed that Iran should be allowed to complete its nuclear program.<sup>23</sup> These respondents did not believe that Iran's nuclear program, even if it was for military purposes, posed a threat to their country. Consequently, in addition to many smugglers who will be motivated by profit, some GCC citizens and residents might also assist in this activity out of political sympathy for the Iranian regime.

## Summary and Conclusions

Iran's nuclear dispute with the West in conjunction with the escalating economic sanctions against that country have had a profound effect on Iran-GCC economic relations. As the leading European economies (Germany, Italy, France, and England), which were Iran's largest trading partners in the 1980s and 1990s, imposed more restrictive sanctions in the past decade, Iran was forced to reorient its foreign trade toward the GCC and Asia. Among GCC countries, the United Arab Emirates (UAE) has emerged as the main beneficiary of this change. The volume of formal and informal trade between Iran and the UAE grew sharply after 2003, and the UAE (along with China) has become one of Iran's leading trade partners. Concern about the cooperation of other GCC countries with U.S. sanctions also motivated Iran to seek closer economic and diplomatic relations with Saudi Arabia, which led to a boost in Iran-Saudi trade volume as well. Overall, had it not been for the escalating sanctions imposed by other nations, Iran-GCC trade would have increased at a significantly slower pace during 2000–2008. This is particularly the case given that Iran's trade with the UAE (which consists primarily of re-export trade with Dubai) accounts for more than 80% of the Iran-GCC trade.

The United States is well aware of the growing reliance of Iran on the UAE (and on Dubai in particular) as a means of evading sanctions. In recent years the U.S. has worked hard to persuade the UAE and other GCC governments to curtail their trade and investment relations with Iran. However, these efforts have been only partially successful. Doing business in Dubai has become more difficult for Iranian firms as a result of the voluntary cooperation of some UAE banks with the financial sanctions against Iran; the UAE government has also increased its inspection of goods bound for Iran. These steps have increased the cost of imports and have made it more difficult for Iran to import large items that cannot be smuggled on small boats. Still, the overall volume of Iran-UAE trade has not suffered a substantial decline, and smuggling activities have increased. There is also no evidence that the flow of Iranian tourists

and travelers to the UAE has been adversely affected by the sanctions.

What lies ahead for Iran-GCC economic relations in the coming years? From a purely economic perspective, both Iran and the GCC countries will have an incentive to expand their trade relations. However, diplomatic and strategic concerns are likely to play an important role as well. As long as the United States continues to rely on sanctions as the primary means of putting pressure on Iran, GCC countries will feel pressured to cooperate with these sanctions. Given the U.S. resolve to stop Iran's nuclear program, these sanctions are likely to intensify, and greater cooperation will be expected of the GCC countries.

The United Arab Emirates in particular is likely to come under considerable diplomatic pressure from the United States. Since its strategic ties with the U.S. are far more important to the UAE than are its economic ties with Iran, UAE leadership is likely to accommodate to this pressure. Oman and Saudi Arabia—which, along with the UAE, account for more than 95% of GCC exports to Iran—will likely also cooperate for the same reason. Another factor that can be expected to encourage more GCC cooperation with the sanctions is GCC leaders' fear of a nuclear Iran. These governments are worried that if Iran acquires nuclear weapons, it might pursue a more aggressive foreign policy in the Persian Gulf and undermine their political stability.

Consequently, we expect the volume of trade between Iran and the GCC to grow at a slower pace than it has over the last several years, and it might even diminish. The volume of illegal trade (smuggling), on the other hand, is likely to increase, but this increase will be smaller than the reduction in formal trade, and it will also be far more costly for Iranian importers. Trade with GCC countries has become crucial for many Iranian businesses and producers that have lost access to European markets and are now facing more sanction-related difficulties vis-à-vis their Asian partners.<sup>24</sup> Given that the United States is also aggressively encouraging Asian countries to impose more severe sanctions on Iran, it is unlikely that Iran can easily find a new trade partner to replace the UAE.

The current factional divisions within the Iranian regime have motivated some political leaders, such as former president Rafsanjani, to openly acknowledge the heavy burden imposed on the Iranian economy by the tightening sanctions. Rafsanjani has also warned that the sanctions are likely to intensify in the near future. If, as predicted, the GCC countries (the UAE in particular) go beyond the UN-approved sanctions and adopt more severe unilateral trade and investment restrictions with respect to Iran, the cost on the Iranian economy could be severe.

## Endnotes

1 Several definitions of “economic diplomacy” are available; for purposes of this Brief, it is defined as a set of economic incentives that a country offers another in order to influence that country’s domestic or foreign policy on a specific issue.

2 One of the issues that still worried the moderate GCC rulers was that Iran continued to support Islamic movements in various Arab countries. Iran’s support for Hezbollah in Lebanon in particular posed a challenge to Saudi efforts to strengthen the moderate Sunni factions in that country.

3 Crown Prince Abdullah of Saudi Arabia attended this conference and met with Iran’s Supreme Leader, Ayatollah Khamenei, and with President Khatami.

4 In February 2009, Bahraini media reported that a high-ranking Iranian official had suggested a territorial claim on Bahrain by noting that Bahrain was Iran’s fourteenth province before it gained independence in 1971. Although the Iranian official later explained that he was simply referring to a historical fact in the context of eighteenth-century conditions, the government of Bahrain reacted angrily and froze Iran-Bahrain diplomatic relations for several weeks. Bahrain also convinced the GCC to issue a warning to Iran about making territorial claims on Bahrain. See [Ghazanfar Ali Khan, “GCC Warns Iran against Making Hostile Remarks,” \*Arab News\*, February 23, 2009.](#)\*

5 For more details on this dispute, see Abraham S. Kurts, “Iran Spars with Kuwait over Arash/Al-Durra Offshore Oil Field,” *Oil Field* (January 2004).

6 Up until 1993, Iran and Sharjeh had partitioned the Abu Musa island under a 1971 agreement. In 1993, Iran occupied the entire island and required foreigners who wanted to enter the Sharjeh section of the island to have an Iranian visa. (Sharjeh citizens are still allowed access to their section of the island.) Iran’s action, which intensified the tensions between Iran and the UAE, was motivated primarily by Iran’s fear that the UAE was planning to station foreign troops in Abu Musa, which is strategically located near the entrance to the Strait of Hormuz.

7 For a detailed account of Saudi-Iran competition for influence in the region, see [Frederic Wehrey, Theodore W. Karasik, Alireza Nader, Jeremy Ghez, Lydia Hansell, and Robert A. Guffey, “Saudi-Iranian Relations since the Fall of Saddam: Rivalry, Cooperation, and Implications for U.S. Policy” \(Rand Corporation, National Security Research Division, 2009\).](#)\*

8 [Haseeb Haider and Martin Croucher, “UN Sanctions to Hit UAE-Iran Trade,” \*Khaleej Times\*, June 29, 2010.](#)\*

9 The share of the four largest European countries (Germany, France, Great Britain, and Italy) in Iran’s goods imports declined from 32% in 2002 to 19.3% in 2008. (Source: IMF, Direction of Trade Statistics, 2010.)

10 “Sanctions Slow Iran’s Trade, but not Stop”, *International Herald Tribune*, August 18, 2008.

11 *Ibid.*

12 The UAE’s foreign policy is dominated by the oil-rich emirate of Abu Dhabi, but the emirate of Dubai also exerts influence as the second richest emirate in the UAE federation. Traditionally the leader of Dubai has served as UAE prime minister, while the presidency has been reserved for the ruler of Abu Dhabi. The emirate of Abu Dhabi has been more willing than Dubai to cooperate with the U.S. sanctions against Iran.

13 [“UAE Freezes 41 Iranian Accounts,” \*Press TV\*, June 28, 2010.](#)\*

14 [“Shell, Vitol Suspend Gasoline Sales to Iran,” \*Market Watch\*, March 10, 2010.](#)\*

15 [“Iran Claims Kuwait, Others Refusing Fuel to Its Planes,” \*Kuwait Times\*, July 6, 2010.](#)\*

16 [“China’s Imports from Iran Decline \(Reuters\),” \*Gulf News\*, June 22, 2010.](#)\*

17 [Noueihed, Lin, “Smuggling to Iran Rife in Dangerous Gulf Waters,” \*Reuters\*, May 12, 2008.](#)\*

18 [Kambiz Foroohar, “Dubai Helps Iran Evade Sanctions as Smugglers Ignore U.S. Laws,” \*Bloomberg\*, January 25, 2010.](#)\*

19 [Babak Dehghanpisheh, “Smugglers for the State: Why Sanctions Won’t Hurt The Revolutionary Guards,” \*Newsweek\*, July 10, 2010.](#)\*

20 [“Oil Smuggling to Iran Stokes Tension in Iraq,” \*Gulf News\*, July 14, 2010.](#)\*

21 [“UAE-Iraq Trade Exchange Exceeded \\$5b in 2009,” \*Today Magazine\*, June 28, 2010.](#)\*

22 [Jiyar Gol, “Travelling the Smugglers’ Route from Turkey to Iran,” \*BBC News: Middle East\*, August 2, 2010.](#)\*

23 [2010 Arab Public Opinion Poll \(Washington, DC: Brookings Institution, 2010\).](#)\*

24 In September, South Korea announced that it will impose new unilateral sanctions on Iran that will go beyond the latest round of UN-approved sanctions.

\* Weblinks are available in the online version found at [www.brandeis.edu/crown](http://www.brandeis.edu/crown)





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