

# LUBRICATED WITH OIL: IRAN-CHINA RELATIONS IN A CHANGING WORLD

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China and Iran are emerging powers with increasingly significant political and economic relations that have regional and global dimensions. In this article, we set out to explore the historical roots, evolution and development of this relationship with a particular emphasis on the period since the Islamic revolution of 1979. Elsewhere, we have examined the role of factors such as the arms trade and technology transfers, and how they have shaped Sino-Iranian relations. However, in light of present economic and political trends, it is the pursuit of energy security and supply that is emerging as a more pressing concern for both states.

We will investigate several central questions. First, what are the incentives for these two otherwise ideologically opposed regimes to forge an increasingly expanding and cordial relationship — especially in the context of declining American political influence in the Middle East — and what does each side gain from this relationship? Second, how much weight is given to economic interests, especially the trade in energy, in facilitating closer relations between the two states? What are the dynamics of petropolitics in this relation-

ship? Finally, in light of the different bilateral relationships the two countries have with the United States — China's expanding trade and political relations versus Iran's acrimonious relations — what are the limitations of their partnership? With respect to this point, we are interested in addressing the different circumstances in which China might perceive its relations with an increasingly isolated and nuclear-driven Iran as a political liability, and under what conditions Iran would be compelled to abandon its "Eastern strategy" and pull away from China. Both Iran and China's regional as well as global political ambitions pose a challenge to their bilateral relationship. Thus, we analyze a variety of circumstances under which their interests may clash, and we weigh them against the strategic objectives motivating their cooperation.

## **HISTORICAL OVERVIEW**

As civilizations with deep historical roots, rich cultural traditions and illustrious imperial pasts, Iran and China have a basis for psychological identification. The fact that the two countries have no history of war and conflict, and that both have suffered the humiliating experience of

neocolonialism, accentuates their civilizational and political identification. This deep sense of historical identity and national pride may partially explain why Iran and China have experienced several revolutions in the twentieth century in which the themes of anti-imperialism and nationalist self-assertion played a prominent ideological role.

The historical ties and encounters between the Chinese and Persian empires go back to the contacts between the Hans and the Parthians in 139 BCE, which culminated in diplomatic and trade relations. The trade route between the two empires — the “Silk Road” — linked China to Central Asia and the Middle East. According to John Garver, the influence of the Persian Empire on ancient China was considerable:

Large numbers of Persians, and later Arabs, settled in Guangzhou and Hanoi (then a part of the Chinese empire). The highly Persianized kingdom of Kushan (a post-Bactarian, post-Yuezhi state established in the Oxus region) became the main center for the transmission of Buddhism to China in the second through the fourth centuries C.E. The first translator of the Buddhist sutras into Chinese was a Parthian (Persian) prince from Kushan. Other Persian and Indian Buddhist missionaries arrived in China via Kushan. Zoroastrianism, Nestorian Christianity and Manichaeism were additional Persian influences on China during the sixth and seventh centuries. Persian influences on Tang China were extensive. Magic routines from Persia were highly appreciated in China. Persian poetry influenced China’s great Tang Dynasty’s poetry. The

game of polo came from Persia and found great favor in Chinese imperial courts. The ritual dances performed in Zoroastrian “fire temples” roused Chinese interest. Persian cuisine found favor in China and greatly influenced Chinese cooking. In the words of one authority, “There was (in Tang China) a great vogue especially in the first half of the eighth century for Iranian objects and customs of all kinds: food stuffs, clothing, furniture, music, and dancing.”<sup>1</sup>

These contacts increased, particularly after the Mongol conquest of both countries in the thirteenth century. There were regular diplomatic missions between Yuan China and Il-Khanate Persia. Chinese astronomical knowledge, printing and paper money were transmitted to Persia and the Near East, while Persian and Arab medicine, alchemy, pharmacology, mathematics and geometry were transmitted to China.<sup>2</sup> Within this rich context of mutual cultural influences and cooperation, contemporary Sino-Iranian relations have mutated and evolved. The leaders of both nations consciously evoke this historical memory as a source of strength and legitimacy for the continuation of a relationship that has been beneficial to both sides. The fact that the two empires had no history of war and conflict left the slate clean, helping to build a mutually beneficial relationship on that foundation.

In the twentieth century, diplomatic contacts and trade relations expanded considerably. While relations between the two countries were restrained, in the aftermath of the Chinese revolution of 1949 relations began to improve by the 1960s. The Communist party’s ascendance to power in China coincided with the CIA-

sponsored coup d'état of 1953 that overthrew the reformist-nationalist leader Mossadeq, restoring the shah to power and bringing Iran into a close alliance with the United States and its West European allies. Thus, Iran was drawn into the Cold War orbit of the United States with its regional and global policy of containing Communism. The shah, however, had his own reasons to keep Mao's government at a distance. Chinese and Soviet support of Iran's Tudeh party — a pro-Moscow Communist party that was committed to the overthrow of the shah's regime — made Tehran a willing partner in the alliance against Moscow and Peking, and the shah supported the United States and South Korea during the Korean War. Following the U.S. lead, Iran also opposed China's admission to the United Nations and sought closer ties with the nationalist government in Taiwan. Nevertheless, "unofficial" trade relations between the two countries continued in the 1950s. The total value of China's trade with Iran from 1950-59 amounted to \$2.5 million.<sup>3</sup>

By the 1960s, however, China-Iran relations went through substantial changes. After the Sino-Soviet political rift, China was looking to counter U.S. as well as Soviet hegemony in the Third World. Having lost the support of its former ally, China was now looking for alliances. Hence, with the emergence of peaceful coexistence and, later, détente in U.S.-Soviet relations in the 1960s, the centrality of Iran's strategic value as an anti-Soviet outpost diminished in the eyes of U.S. policy makers. By 1964, the U.S. decision to sell arms to Iran, rather than provide it with military grants, convinced the shah that he had to assume a more "independent" foreign-policy posture.

By 1965, Iran began to abstain from voting on China's UN membership rather than oppose it. While Iran continued to support the anti-communist Baghdad pact (CENTO) and remained suspicious of China's support of the Tudeh party, several important political developments encouraged rapprochement. With the escalation of China's anti-Soviet campaign in the late 1960s, the shah, who was chiefly concerned with the threat of Iran's neighbor to the north, found a potential ally in China. Regionally, the defeat of Arab armies by Israel in 1967 enhanced Iran's strategic position in the region and rendered the shah more assertive. He recognized the People's Republic of China for the first time in 1967, and by 1969 declared his support for China's membership in the United Nations. Despite the absence of formal political relations between the two countries, trade relations during the 1960s became 20 times greater than during the previous decade.<sup>4</sup>

With the British military withdrawal from the Persian Gulf and the signing of the Soviet-Indian friendship treaty, China became increasingly alarmed about Moscow's penetration into the Persian Gulf and sought new alliances with Iran and Pakistan to counter it. As the United States and a number of Western and non-Western nations began their rapprochement with China, the shah's regime felt, in 1971, more comfortable doing the same. China also saw in Iran a viable potential trade partner and energy provider. Iran perceived China to be a good counterbalance to both the United States and the Soviet Union, hoping that relations with China would lend Tehran much leverage in international affairs. In particular, friendship with China would obligate it to discontinue its support of

revolutionary movements in the Persian Gulf and prevent destabilization of the region. Once China ceased its support in 1971 for the Popular Front for the Liberation of Oman, which the shah opposed militarily, there was nothing standing in the way of full normalization between the two nations. On August 17, 1971, in a joint communiqué, the two countries established diplomatic relations. The shah's sisters (Princesses Ashraf and Fatimah) visited China on separate occasions in 1971, and the chairman of the Chinese Communist party, Hua Guofeng, visited Iran in 1978. The establishment of diplomatic relations eventually led to a substantial increase in trade relations. The 1972 trade figures were six times higher than those of 1971, the 1973 figures were more than ten times greater than the 1971 figures, and the 1978 figures were about 20 times greater than in 1971.<sup>5</sup>

Concerned about possible attendant instability in China-Iran relations following the Islamic Revolution in 1979, the Chinese leadership moved quickly to recognize the new government and express its hope that friendly relations would continue. According to some reports, in order to mend fences with the new power brokers in Tehran, Hua Guofeng went so far as to apologize for his visit to Iran and expression of support for the shah in 1978.<sup>6</sup> The Chinese leadership found it useful to send delegations of Chinese Islamic Association members to Iran to cement the relationship. Nevertheless, in the immediate aftermath of the revolution, total trade between the two countries dropped from \$118 million in 1978 to \$68 million in 1979.

The onset of the Iran-Iraq War in September 1980 forced China into a delicate balancing act. China considered both countries as allies and tried not to take

sides, urging a peaceful resolution of the conflict. Beijing also welcomed Iran's condemnation of the Soviet invasion of Afghanistan and encouraged Iran to mend its relations with the United States. As Washington attempted to punish the Iranian government for allowing militant students to take its embassy personnel hostage, the Chinese leadership displayed its willingness to part ways with the United States in order to maintain its relations with Iran. Like the Soviet Union, in 1980, the Chinese government refused to support the UN arms embargo against Iran under Security Council Resolution 598. The Chinese government also abstained from voting on a U.S.-sponsored resolution to impose economic sanctions on Iran.

During the 1980s, Iran's foreign policy was redefined under the slogan "neither East nor West" in defiance of both the Soviet Union and the United States. This policy dovetailed nicely with the Chinese government's global political agenda. Thus, the two countries, using the ideological themes of anti-imperialism and Third World solidarity, forged a closer alliance. While refusing the Kuwaiti government's request to cooperate with the United States and the Soviet Union to protect Kuwaiti ships against Iranian gunboat attacks, China condemned the U.S. downing of an Iranian passenger plane over the Persian Gulf in 1988. The Islamic Republic, in turn, supported the Chinese government's crackdown on the Tiananmen Square democracy movement as a legitimate initiative to restore law and order.

In 1989, the Iranian president, Ali Khamenei, visited China and assured Deng Xiaoping of Iran's commitment to expanding friendly relations between the two nations. As a result of this closer relationship, Sino-

Iranian trade increased substantially in the 1980s. Total trade between the two countries increased from \$627 million to \$1.627 billion. In addition, cultural relations between the two nations also expanded: student exchanges, scholarship and research programs, increased artistic interactions, and the waiving of visa requirements for tourists.<sup>7</sup>

The end of the Iran-Iraq War in 1988 provided China with a new opportunity to participate in much-needed economic reconstruction and emerge as the provider of arms and technology for Iran. Strained Iranian relations with the United States and Western Europe rendered Iran an alluring market for China. This is also the period when China's economy began to grow rapidly, exponentially increasing China's need for new sources of energy supply and investment markets. Iran needed a reliable buyer for its oil and gas and a supplier of military equipment and weapons systems. This made the rationale behind the mutually beneficial relationship even more patently clear to both sides.

In addition to material incentives, both sides found each other to be useful potential allies in global affairs. As a member of the UN Security Council, China can provide Iran with a security blanket, especially now that Iran has come under great pressure from the United States and its allies for its uranium enrichment. Moreover, Iran's emergence as a major player in the Middle East and the global oil market is helpful to China's political and economic interests in the region. China also hopes its close relationship with the Islamic Republic will help it rein in its own restive Muslim minority in Xinjiang province, where separatist activities threaten stability in the region.

Iran-China economic relations are wide-ranging and extensive. China has built Tehran's subway system, dams, fisheries and cement factories and is currently engaged in many other reconstruction projects. China is also a major provider of consumer goods to Iran; by 2003, it was responsible for 9.5 percent of Iran's total imports. In what follows, we will discuss in detail the most important aspect of this relationship: energy.

### THE ENERGY CONNECTION

With the ascendance of Deng Xiaoping to power in 1976 and the inauguration of open-door and economic-liberalization policies, China's economic growth began to take off in earnest. This dramatic economic development exponentially increased China's need for additional sources of energy. China's domestic oil and gas reserves (respectively, 2 percent and 1 percent of total world reserves) were sufficient to provide for domestic energy needs until 1992. But, as Charles Ziegler puts it, "From 1992 to 2005 the People's Republic of China went from self-sufficiency in petroleum to dependence on imports for over one-third of total consumption. China is the world's second largest energy consumer, and in 2004 it surpassed Japan as the world's number two oil importer."<sup>8</sup>

This dramatic increase in energy demand would be appreciated more if we compare China's demographic trends since 1970 to its energy demand. In 1971:

China's share in the world's primary energy demand was a mere 5 percent (with 23 percent of the world's population); in 1995, China's share of the world's population slipped to 21 percent, while its share of energy

demand more than doubled to 11 percent. China's consumption of oil surpassed its domestic production in 1993, and imports have grown rapidly in recent years. In 2003, China's imports of crude oil increased by 31 percent over 2002, and demand for crude rose by 35 percent in 2004. The International Energy Agency estimates that by 2020 China's share of primary energy demand will increase to 16 percent, while its share of population shrinks to 19 percent.<sup>9</sup>

Another important factor contributing to China's spiraling demand for oil and gas is the need to reduce the use of coal, which is responsible for about three-fourths of the Chinese domestic energy supply. With the increasing environmental degradation and high level of pollution in major Chinese cities (carbon dioxide, sulfur dioxide and particulates), there is an urgent need to switch to other sources of energy, thus the increasing Chinese demand for imported natural gas, which generates much less carbon monoxide. The booming automobile industry is another source of the surge in energy demand. Car sales in 2004, for example, were about 5 million, making China the third-largest car market after the United States and Japan.<sup>10</sup>

This stark rise in China's energy demand, paired with Iran's vast oil and gas reserves, makes the energy connection one of the most significant pillars of this relationship. According to *Oil and Gas Journal*, with 132.5 billion barrels of oil, roughly 10 percent of the world's total supply, Iran has the third-largest proven reserves of oil, behind Saudi Arabia (266.8 bbl) and Canada (178.8 bbl).<sup>11</sup> However, if you convert natural-gas reserves into barrels of oil equivalent (boe), Saudi Arabia

has 302.5 boe, and Iran has 301.7. Russia's hydrocarbon reserves, the world's third-largest, are 198.3 boe.<sup>12</sup> This means Iran's hydrocarbon resources are almost equal to those of Saudi Arabia and much greater than those of Russia. What makes Iran's future energy potential even more impressive is the fact that, in contrast to its vast reserves, Iran's extraction rate is relatively low. Given the proper amount of investment and technology, Iran would have the capacity to boost its production substantially and become an even larger provider of energy for China.

With a capacity of 4.2 mb/d, Iran is the fourth-largest producer in the world, behind Saudi Arabia (11.1 mb/d), Russia (9.5 mb/d), and the United States (8.2 mb/d). Iran also possesses the second-largest gas reserves in the world, trailing only Russia. Iran is the second-largest provider, after Saudi Arabia, of oil to China; the two countries have signed oil and gas contracts worth \$70 billion. In fact, while Chinese exports to Iran are very diverse, ranging from electronics and machinery to arms, consumer goods and textiles, oil accounts for 80 percent of Chinese imports from Iran. By 2002, Iran was responsible for more than 15 percent of the PRC's annual oil imports.<sup>13</sup>

China first purchased Iranian oil under the shah's regime in 1974, and the amount increased significantly in the 1980s. Whereas China imported 300,000 tons of oil in 1977, this amount reached one million tons (25,000 b/d) in 1982, and then two million tons (40,000 b/d) by 1989-90. In 1995, the Iranian News Agency announced that it would expand production to 60,000 b/d. In the same year, in order to expand oil exports to China and enable China to refine the imported crude faster, Iran agreed to

invest \$25 million in China's oil-refining industry. In 1997, China pledged to expand the imports of Iranian oil from 70,000 b/d to 100,000 b/d in 1999 and to 270,000 b/d in 2000.<sup>14</sup> By 2003, China was importing 12,393,834 metric tons of oil and it quickly surpassed Japan to become the world's second-largest consumer of oil and petroleum products. These statistics indicate that energy security is very important to China's continued prosperity, and Iran so far has emerged as a reliable supplier that in return provides China with a lucrative market for investment and its consumer goods.

Due to U.S.-imposed economic sanctions since 1980, Iran's oil infrastructure — exploration, refining and downstream production — has been deteriorating steadily. In 1996, the Clinton administration's Iran-Libya Sanctions Act imposed tough penalties on foreign companies and individuals found to be investing more than \$20 million in oil and gas development in Iran. This initiative further hampered Iran's ability to modernize and expand its production capabilities. This proved to be a boon for China. Conscious of Iran's urgent need to explore its vast oil reserves and rebuild its war-torn and decrepit oil infrastructure, China offered to rebuild the facilities and engage in joint-venture exploration and development of new oil and gas fields. In doing so, China hoped to lock into the Iranian oil market for the long haul. After allaying Iranian fears about Chinese technological capabilities, the two countries signed an agreement in 1997 for cooperation in prospecting and exploration. In 1988, a Sinopec subsidiary, Shengli Oil Company, transferred a complete set of China-made oil equipment to Iran.<sup>15</sup>

As the West European oil companies began to object to the "extraterritoriality" of U.S. sanctions and defied them, China gained confidence that, despite intense anti-Chinese sentiments in the U.S. Congress, Washington could not single out China for punitive action. China cited the 1999 signing by Royal Dutch Shell of a deal with Iran worth \$850 million to rebuild Iranian oil fields damaged during the Iran-Iraq War to justify its own investment in Iranian oil and gas fields.<sup>16</sup>

The discovery of vast reserves in the Azadegan oil field in 1999 (estimated to have 26 billion barrels of oil, making it one of the largest undeveloped oil reserves in the world, worth \$2.6 billion) posed a dilemma for the leaders of the Islamic Republic. Which one of their great Asian trading partners should receive the lucrative exploration rights, China or Japan? In 2000, President Khatami decided to grant the development rights to a Japanese firm. In order to prevent a rift with China, the National Iranian Oil Company (NIOC) granted the China National Petroleum Corporation (CNPC) an \$85 million contract to drill 19 wells in existing natural-gas fields in Southern Iran. This was followed by a \$13 million oil contract between the two in 2001.<sup>17</sup>

A combination of U.S. pressure on Japan to withdraw its proposed \$3 billion investment in the development of the Azadegan field, and Japan's concern about Iran's pursuit of a nuclear capability, culminated in the Japanese hesitating and missing the deadline of June 2003 to reach a conclusive agreement. Soon afterward, Sinopec expressed interest in taking on the Azadegan exploration and development. According to Sinopec officials, in 2004, the U.S. embassy in Beijing requested that

Sinopec withdraw its bid, but Sinopec refused. After Iran signed onto an additional protocol requested by the International Atomic Energy Agency (IAEA) and halted its uranium-enrichment program in 2003, Japan decided to sign onto the Azadegan project in 2004 with an escape clause that would allow Japan to cease cooperation should Iran and the IAEA come to confrontation. Eventually, under relentless U.S. pressure, by October of 2006, Japan's INPEX Holding, Inc., had pulled out of all but 10 percent of the stake in the Azadegan field.

After signing the Azadegan deal with Japan in 2004, however, Iran reached a \$20 billion balancing agreement with China to sell it 2.5 million metric tons of liquefied natural gas (LNG) annually over a period of 25 years starting in 2008, making it the world's largest purchase of natural gas to date.<sup>18</sup> A few months later, Sinopec and NIOC signed another contract that would allow China to buy \$250 million tons of Iranian LNG for the next 30 years. This deal is estimated to be worth \$70-100 billion. In addition, CNPC was also given the right to invest in the exploration of the Yadavaran oil field in exchange for the right to purchase 150,000 b/d at the market price, once the oil field is operational.<sup>19</sup>

China has also become an active participant in Iran's development of Caspian Sea oil and gas and the modernization of its facilities in Neka and other regions. China is sympathetic to Iran's attempt to bring Caspian oil and gas through pipelines to the southern Iranian ports for shipping to Europe and Asia. The United States is adamantly opposed to this initiative, which will expand Iran's economic and strategic clout. China, however, remains undeterred so far by the negative

U.S. reactions to its attempt to forge closer relations with the Islamic Republic. China's aggressive cultivation of the Iranian market has been fruitful. China now supplants Germany and other European powers, which until 2006 were Iran's largest trade partners. In 2007, Iran-China trade volume increased by 27 percent and reached \$15 billion.<sup>21</sup>

These developments portend the increasing possibility that the Chinese drive to secure energy sources and investments in Iran may bring it into conflict with the United States. Since this looming showdown is not confined to Iran but extends into Asia, Central Asia, Africa, Latin America and the Middle East at large, a closer look at the case of Iran-China energy politics may provide a detail of the larger picture of China's increasing power and influence, particularly in the Third World.

### **IRAN-CHINA-U.S.-RUSSIA RELATIONS**

According to some scholars, there is an emerging "axis of oil" constituting Russia (a major producer), China (a growing consumer) and the nationalist oil-producing states (most notably, Iran, a major producer). Their interests converge, and they are now challenging U.S. hegemony on a wide range of issues globally. The frustration of U.S. efforts to impede Iran's drive for nuclear power is cited as an example of this new counter-hegemonic petroleum bloc.<sup>22</sup> The creation of the Shanghai Cooperation Council, in which Russia and Iran are members, is partially designed to roll back growing U.S. influence in Central Asia and the Caucasus.

A salient issue in considering the vicissitudes of this new petropolitics is the fact that 72 percent of global petroleum

reserves are now controlled by nationally owned companies (NOCs). States use oil as a politicized commodity for strategic purposes. Unlike privately owned companies, NOCs are the arms of states and may not function according to the laws or logic of the marketplace. As the demand for oil, spurred by impressive economic growth in China and India, has outstripped global supply, it has put upward pressure on price. This, in turn, has provided abundant petrodollars to producers such as Russia and Iran and has enabled them to assert their political agenda internationally. Iran's increasing financial support for Hezbollah in Lebanon, the Shiites in Iraq, and Hamas in Palestine, as well as a \$2 billion joint-development project signed with Venezuela in January 2007 that is partially aimed at bolstering "anti-imperialist" movements in the Third World, must be seen in this light. Increasingly, oil-producing nations are using the leverage that their petro-power gives them to push back against the United States when they perceive infringements on their vital interests.<sup>23</sup>

In 2002, when Hu Jintao became the general secretary of the Communist party, China opted for a "going out" policy that encouraged its three main national oil companies to look for opportunities to invest in overseas exploration and production projects. The goal of this strategy was to secure long-term sources of energy supply and the means to transport them. In pursuit of this goal, China has demonstrated the willingness to pay premium prices, supply exploration and production capital, and offer other side deals and soft loans in order to get the contracts it seeks. The "going out" strategy and its increasing penetration of the oil-producing nations have the potential of bringing it into con-

frontation with the United States and Japan, the other two major oil importers. Whereas Japan has usually assumed a docile political posture versus the United States on major issues of contention, China has proven to be more assertive in protecting what it regards as its core national interest. It is willing to challenge Washington on policies it regards to be a manifestation of "hegemonic unilateralism." But China's energy-driven penetration of the Middle East also provides an alternative foreign-policy and trading partner for states such as Iran and Syria, which U.S. policy actively seeks to isolate and punish.<sup>24</sup>

China sees Russia's political behavior as a useful example: Moscow maintains good relations with both Iran and the United States, but is willing to defy U.S. punitive policies against Iran in order to protect its own national interests. As an emerging sovereign power, China has its own distinct global interests, which at times may be at odds with those of the United States. So far as Chinese leaders are concerned, this is something that Washington should learn to live with. Chinese protection of Iran on the nuclear issue reflects how Chinese leaders see the partnership with Iran: a strategic relationship that is tied to its energy security and, hence, its national security.

While China has the necessary capital, it currently lacks the technological capability to substantially upgrade and modernize Iranian oil infrastructure in order to expand energy exports. Much of that technology is in the hands of American and Western European companies. According to the IAEA, in order to expand its output substantially, Iran needs about \$160 billion to revamp its energy infrastructure over the next 25 years. Unlike Saudi Arabia, it does

not possess such a cash surplus and is thus to a large extent at the mercy of foreign investors. Current U.S. policy prohibits American energy companies from doing business in Iran, and recently, Washington has been aggressively threatening to impose fines and other punitive measures on those Japanese and European companies that are interested in doing business in Iran. A combination of these two factors — an unattractive business climate and contractual terms sometimes with political strings attached — keeps potential investors away. Consequently, since Iran opened up its oil and gas sector to foreign investment in 1994, it has attracted only \$15-20 billion in Japanese and European investment. With the United Nations having imposed sanctions on Iran in 2006, 2007 and 2008, and with the possibility of additional sanctions in the future, there would be additional pressures on potential investors not to invest in Iran.<sup>25</sup> With the ascendance of President Nicolas Sarkozy to power in France in 2007 and his aspiration to align French foreign policy more closely to the United States than his predecessors, the Bush administration seems to have found another close ally in addition to Great Britain on its nuclear standoff with Iran. Spearheaded by the French government, America's European allies are contemplating "a far broader cutoff of bank lending and technology to Iran than any tried so far."<sup>26</sup> If the French government's initiative calling for a separate European sanction in addition to the U.S. government drive to impose an additional set of UN sanctions on Iran succeeds, this would have substantial bearing on Iran's ability to expand its energy production capabilities.

Iran's energy-production woes do not stop there. While Iranian officials boast of increasing capacity to 7 mb/d a day by 2014, most informed analysts argue to the contrary. According to Roger Stern of Johns Hopkins University, for example, the Islamic Republic's need for nuclear power is not driven merely by its ambitions for regional supremacy, but also by a deep crisis in Iran's oil industry. It is in dire need of modernization. Without it, Iran's oil output is going to diminish dramatically within a decade. Indeed, Iran's refining capacity has declined to a point that it has to import some of its gasoline in order to satisfy the domestic need. Stern concludes that since more than 80 percent of Iran's foreign exchange comes from the export of oil and gas, the Islamic Republic needs nuclear power as a source of domestic energy. This would allow the government to export its oil and gas in order to generate the income to carry out its programs. Furthermore, the oil is highly subsidized by the state, thus very cheap for the consumer (30-40 cents per gallon). The total domestic energy subsidies amount to \$20-30 billion a year and cost the government 15 percent of its GDP. This means selling the oil domestically is unprofitable. Having nuclear power to provide for domestic needs would allow the government to sell most of the production capacity abroad and generate additional income.<sup>27</sup> The imposition of gasoline rationing in June 2007, which provoked unrest and massive resentment, is testimony to the crisis of the second-ranking oil state in the world that has to import much of its gasoline for domestic consumption from the Arab states in the Persian Gulf and from Venezuela of late.

Since 1980, energy demand in Iran has risen 6.4 percent, while supplies have

grown at an annual rate of 5.6 percent. Exports have also stagnated since the peak year, 1996. An indication of its declining capacity to produce oil is that, for the last two years, Iran has been unable to meet its OPEC production quota. While the price of energy has risen dramatically in the last three years due to increased demand, Iran's production capability has fallen. If present trends continue, there would be a decline of 33-46 percent in Iran's exports by 2011, asserts Stern, and there would be no Iranian oil to export by 2015. Iran earns \$50 billion a year in oil exports. If the estimated decline of 10-12 percent annually materializes, export income from oil could be halved in five years. Therefore, concludes Stern, "It seems plausible that Iran's claim to need nuclear power might be genuine, an indicator of distress from the anticipated export-revenue shortfalls. If so, then the Iranian regime may be more vulnerable than is presently understood."<sup>28</sup> If Stern's analysis is accurate, a legitimate question arises: Does Iran have the resources to finance its nuclear project to a successful completion? Thus, if the current Iranian regime has decided not to pursue weaponization of its nuclear program as the U.S. National Intelligence Estimate (NIE) released in December 2007 indicates, that decision may be dictated as much by financial considerations as by political calculations.

The future productive oil capacity of Iran (currently 3.6 - 4.2 mb/d) remains in doubt for several reasons: a combination of rising domestic energy consumption, due to a doubling of the population in the last 25 years, and a booming automotive industry that produces 1 million cars annually (the most in the Middle East); a decreased refining capacity due to damage to Iranian

refineries during the Iran-Iraq War (1980-88); and a lack of investment. In fact, Iran currently produces 30 percent less oil than it produced in 1979, the year of the Islamic Revolution. Without new investment in the industry, Iran would lose about 300,000 b/d in production capacity annually.<sup>29</sup> As Muhammad Hadi Nejad-Hosseini, Iran's deputy oil minister for international affairs, has asserted, "If the government does not control the consumption of oil products in Iran... and at the same time, if the projects for increasing the capacity of the oil and protection of the oil wells will not happen, within 10 years, there will not be any oil for export."<sup>30</sup> As long as oil prices continue to remain high, the decline in production capacity would be offset. However, should prices plummet in the future, Iran would find itself in a precarious financial situation.

To punish Iran for its nuclear ambitions, the Bush administration increased political pressure on Iran by playing a key role in the imposition of UN sanctions on top of the U.S.-imposed sanctions begun in 1980. The Bush administration hopes to further weaken and isolate the Islamic Republic with the apparent ultimate goal of regime change. Ironically, the sanctions, and their debilitating impact on Iran's oil and gas infrastructure, have made nuclear energy a more alluring alternative to Tehran.

The U.S. government also ratcheted up the pressure on international banks that do business with Iran, urging them to withdraw their loans and investments. The Justice Department reportedly investigated several banks that do business in Iran to determine if they have violated U.S. sanctions laws. In 2005, for example, the Dutch Bank ABN Amro agreed to pay \$80 million in fines due to "improper transac-

tions from within Iran. UBS Bank and Credit Suisse of Switzerland recently announced they were suspending most new business with Iran, and British-based HSBC said it would no longer accept dollar transactions from within Iran.<sup>331</sup> Several European banks that had agreed to finance some of the Iranian oil and gas contracts have recently cancelled them. This pressure is “threatening dozens of projects, including the development of Iran’s two massive new oil fields, which could expand output by 800,000 barrels a day over the next four years.”<sup>332</sup> U.S. officials have also warned China that they would hold Beijing “accountable under Washington’s unilateral sanctions laws if it proceeds with a \$16 billion project to develop Iran’s North Pars gas field.”<sup>333</sup> The United States in cooperation with England and France is also attempting to directly target “the finances of a wide array of Iranian companies.” Hence, the designation of the Quds force, an elite unit of the Iranian Revolutionary Guards Corps, as “terrorist” is intended to give the Bush administration and its European allies the ability “to squeeze off its international financing.”<sup>334</sup> These developments further accentuate Iran’s vulnerabilities in meeting its contract obligations to other nations, most notably China. Should the present attempt at economic strangulation of the Islamic Republic continue, given its negative impact on energy production, it would cast some doubt on the viability of Iran as a reliable long-term energy supplier, despite its vast resources.

Many of the technologies that Iran needs in order to improve oil and gas recovery from both old and new fields lie in the hands of U.S. companies. Consequently, “Iran is falling behind its neighbors

in the exploitation of joint fields, like the South Pars gas field it shares with Qatar, because they have access to U.S. oil technologies.”<sup>335</sup> However, the release of the NIE has induced some European allies to relax their financial restrictions on Iran, and yet others to sign lucrative long-term energy contracts. A recent example of this is the Iran-Switzerland signing of a 25-year gas deal worth \$42 billion in March of 2008. Iran has also signed gas deals with Malaysia and India, and is negotiating an energy deal with Turkey. These developments may entice other exporters of energy — most notably Europeans, who are eager to diversify their energy supply and reduce their dependence on Russian gas — to end energy contracts with the Iranian government as well.<sup>36</sup> Increasingly, many countries seem to be willing to defy the U.S. government’s ban on investments worth more than \$20 million in Iran’s energy sector. These new developments may provide the Iranian government with the breathing space and the necessary financial assets to expand its production capacity. The long-term impact of the NIE report may also produce a grand bargain between Iran and the United States in the post-Bush era. Resolving some of the most significant outstanding issues of conflict between the two nations would go a long way towards revamping and revitalizing the Iranian oil industry.

After the initial rejection of the Baker-Hamilton-led Iraq Study Group recommendation to engage Iran and Syria and enlist their support as a way out of the Iraqi quagmire, in March 2007, the Bush administration embraced the idea of negotiation with Iran and Syria to get their support in bringing stability to Iraq. However, given the Bush administration’s coercive diplomacy and anti-

Iran rhetoric, the possibility of a rapprochement between the two nations under the current administration seems unlikely. In fact, the joint offensive of United States and Iraqi security forces against the Shiite Mahdi army militia in Basra and Baghdad in April and May 2008 has escalated the tensions between the United States and Iran, causing the Ahmadinejad administration to call off any further negotiation with the United States over Iraqi security. These developments, in turn, have made Washington increase pressure on Iran. Inadvertently, the Bush administration's attempt to isolate Iran benefits Russia and China and gives them greater access to the lucrative Iranian market and solidifies their mutual political ties.

Mindful of the developments discussed above, Russia has stepped in to fill the vacuum. While unhappy with Iranian President Mahmoud Ahmadinejad's policies, Moscow does not support a confrontational American approach toward Iran on the nuclear issue. As Russia is the major provider of nuclear technology and armaments to Iran, and has extensive economic ties to Tehran, it stands to lose financially and politically.<sup>37</sup> Russian President Vladimir Putin's visit to Tehran to attend the summit of five Caspian Sea nations on October 16, 2007, in which he warned, "We should not even think of making use of force in this region," was clearly designed to be a response to the Bush administration's military threats against Iran. While Russia has voted for two UN Security Council resolutions imposing economic sanctions on Iran, it blocked the attempt by the Bush administration to impose a third set of sanctions against Iran in the absence of clear evi-

dence that Iran is on the threshold of acquiring nuclear weapons. In his visit to Tehran, the first for a Russian leader since 1943, Putin expressed his desire for a "deeper" relationship between the two countries.<sup>38</sup>

On the energy front, Russian oil companies, while not as advanced technologically as their Western counterparts, have the capability to increase the productivity of the older Iranian fields and develop new ones as they are found. More important, Gazprom, Russia's state-owned oil and gas giant, has offered the Islamic Republic to coordinate and facilitate Iran's gas exports. According to one estimate, Russia and Iran together control almost 20 percent of global oil and 50 percent of the world's proven reserves of natural gas; "If they coordinated their production and marketing decisions, these two countries could be twice as dominant in the international gas market as Saudi Arabia is in the global oil market."<sup>39</sup> The announcement by President Putin on February 1, 2007, that Russia is considering an OPEC-like cooperation with Tehran on the sales of Iran's natural gas adds credence to the possibility of an Iran-Russia energy partnership,<sup>40</sup> Iran's supreme leader, Ayatollah Khamenei, has also given his blessing to the deal.

Such a partnership would clearly undermine U.S. attempts to isolate and increase the economic and political pressure on Iran. These developments may partially explain why China has edged closer to both Russia and Iran in recent years and has sought to have a coordinated strategy that would stand a better chance of success against U.S. unilateralist policy initiatives and political pressures.

## CONCLUSION

The Iranian revolution has run its course. Many Middle East scholars now regard Iran as a status quo power. Barring a radical shift in Iranian foreign policy beyond the rhetoric and bluster of the “second-generation revolutionaries” led by Ahmadinejad, and given the significance of the energy connection discussed above, Iran-China relations are likely to expand. However, in the unlikely case, that would Iran assume a more belligerent foreign-policy posture, substantially escalating tensions with the United States and its European allies, the Chinese government may decide to distance itself from the Islamic Republic.

In less than two years, we may see very different administrations in Iran and the United States, marking an end to the reign of neoconservatives in Washington and neopopulist ideologues in Tehran. In such an atmosphere, an Iran-U.S. rapprochement could not be ruled out. Should this scenario materialize, Iran might abandon its “eastern strategy” and forge

better relations with the United States and the European Union. In that case, the future expansion of Iran-China relations would have a slower pace and more limited scope. Since the publication of the NIE in December 2007, and the revelations that Iran has not been pursuing a nuclear weapons program since 2003, the likelihood of a U.S. military attack on Iran has diminished. In light of this new development, it has also become more difficult to marshal the support of the European allies for the imposition of additional sanctions on Iran. Should a grand bargain between Tehran and Washington materialize in the post-Bush era, induced by financial and political incentives, Tehran would be in a position to forge closer relations with both China and the United States. In the meantime, however, as the policies of the Bush administration degrade American political capital and escalate anti-American sentiment in the region, China and Iran have new opportunities to fill the vacuum and solidify a relationship that has served both sides quite well.

<sup>1</sup> John W. Garver, *China and Iran: Ancient Partners in a Post-Imperial World* (University of Washington Press, 2006), p. 14.

<sup>2</sup> *Ibid.*

<sup>3</sup> Mohamed Bin Huwaidin, *China's Relations with Arabia and the Gulf* (Routledge-Curzon, 2002), pp. 153-154.

<sup>4</sup> *Ibid.*, pp. 154-155.

<sup>5</sup> *Ibid.*, p. 159.

<sup>6</sup> *Ibid.*, p. 160.

<sup>7</sup> *Ibid.*, pp. 164-165.

<sup>8</sup> Charles E. Ziegler, “The Energy Factor in China’s Foreign Policy,” *Journal of Chinese Political Science*, Vol. 11, No. 1 (Spring 2006), p. 1.

<sup>9</sup> *Ibid.*, p. 4.

<sup>10</sup> *Ibid.*, p. 7.

<sup>11</sup> *Oil and Gas Journal*, Volume. 103, No. 47 (Dec.19, 2005). From U.S. Energy Information Administration. <http://www.eia.doe.gov/emeu/international/petroleu.html>. As cited by Flynt Leverret & Pierre Noel, “The New Axis of Oil,” *The National Interest*, No. 84 (Summer 2006), pp. 63-71.

<sup>12</sup> Flynt Leverett, “The Geopolitics of Oil and America’s International Standing,” Testimony to the Committee on Energy and Natural Resources, United States Senate, January 10, 2007, p. 6.

<sup>13</sup> Liangxiang Jin, “Energy First: China and the Middle East,” *Middle East Quarterly*, Vol. 12, No. 2 (2005),

<http://www.meforum.org/article/694>.

<sup>14</sup> Bin Huwaidin, op.cit., pp. 165-172.

<sup>15</sup> Garver, op.cit., pp. 266-268.

<sup>16</sup> Ibid., p. 268.

<sup>17</sup> Ibid., p. 269.

<sup>18</sup> Roger Howard, *Iran Oil: The New Middle East Challenge to America* (London & New York: I.B. Tauris, 2007), p. 95.

<sup>19</sup> Garver, op.cit., p. 271.

<sup>20</sup> Ibid., pp. 272-275.

<sup>21</sup> Kamal Nazer Yasin, "Iran-US: Prospects for a 'Hot War'," *The International Relations and Security Network* (ISN), October 1, 2007.

<sup>22</sup> Flynt Leverett & Pierre Noel, "The New Axis of Oil," *The National Interest*, No. 84 (Summer 2006), pp. 63-71.

<sup>23</sup> Ibid., p. 65.

<sup>24</sup> Ibid., p. 68.

<sup>25</sup> Flynt Leverett, "Race for Iran," *The New York Times*, June 20, 2006. In an attempt to address the reluctance of foreign investors to invest in Iran's energy sector, the Islamic Republic has provided additional incentives to foreign investors of late. This new initiative reportedly has culminated in the signing of a \$10 billion deal with Spain's Repsol and the Royal Dutch Shell Oil Company in January 2007 to develop Iran's offshore oil fields.

<sup>26</sup> David E. Sanger and Thom Shanker, "Washington Sees an Opportunity on Iran," *The New York Times*, September 27, 2007.

<sup>27</sup> Roger Stern, "The Iranian Petroleum Crisis and United States National Security," *Journal of National Academy of Science* Vol.104, No. 1 (January 2, 2007), pp. 377-382. For a study of Iran's gasoline crisis, see Abbas William Samii, "Iran Considers Gasoline Rationing," *The Daily Standard*, February 7, 2007.

<sup>28</sup> Stern, *ibid*. See also "Iran's Nuclear Drive Linked to Looming Oil Crisis: US Study," Agence France Presse, December 25, 2006. See also "Iranian Oil," *The Washington Post*, December 29, 2006, and "Iran Seeks to Emulate North Korea's Economic Catastrophe," <http://engram-backtalk.blogspot.com> 2006/12/Iran-seeks-to-emulate-north-korea.html. posted by Engram 12-2-06.

<sup>29</sup> Elliot Hen-Tov, "Understanding Iran's New Authoritarianism," *The Washington Quarterly*, Vol. 30, No. 1 (Winter 2006-07), p. 170.

<sup>30</sup> Kim Murphy, "U.S. Puts Squeeze on Iran's Oil Fields," *Los Angeles Times* January 7, 2007. See also *The New York Times*, January 11, 2007. This is also confirmed by a statement from Iran's oil minister in September 2006. Mr. Kazem Vaziri-Hamaneh announced that without foreign investment, the annual output of Iranian oil fields would fall by 13 percent. See Engram, op.cit.

<sup>31</sup> Murphy, *ibid*.

<sup>32</sup> Ibid.

<sup>33</sup> Ibid.

<sup>34</sup> Neil King Jr., "U.S., Europe Look More Likely to Pressure Iran outside of U.N.," *The Wall Street Journal* September 26, 2007.

<sup>35</sup> *The Wall Street Journal*, December 26, 2006.

<sup>36</sup> *Tehran Times International Daily*, May 2008.

<sup>37</sup> Mark N. Katz, "Putin, Ahmadinejad and the Iranian Nuclear Crisis," *Middle East Policy*, Vol. 13, No. 4 (Winter 2006). An example of Russia's increasing frustration with the policies of Ahmadinejad's administration manifested itself in Moscow's decision on March 12, 2007, to indefinitely postpone the delivery of the nuclear fuel and the launch of Bushehr nuclear reactor, supposedly due to Tehran's default on its payments, something that Iranian government denies. The Islamic Republic alleges that Russia is bending to Western pressures. See *The Washington Post*, March 12, 2007.

<sup>38</sup> Nazila Fathi and C.J. Chivers, "In Iran Putin Warns against Military Action," *The New York Times*, October 17, 2007.

<sup>39</sup> Flynt Leverett, "Race for Iran," op.cit.

<sup>40</sup> Steven Lee Meyers, *The New York Times*, February 2, 2007.