Sweet Regime (Change)

My next meeting on the rising Persian Gulf crisis will take place in London a few weeks from now with a possible continuation on the Continent directly thereafter. I'll have more to say about what is at stake when we are a bit closer.

But some contentious matters surrounding the resumption of US sanctions against Iran are already intensifying.

On one front, Europe is currently rushing to meet a beginning of July deadline from Tehran to fashion ways of avoiding the renewed US oil sanctions.

Moves already approved include direct connections between European central banks and Bank Markazi (the central bank of Iran), provisions to provide sovereign support to currency access, EU "blocking sanctions," legislation intended to protect member nation businesses from the imposition of US secondary sanctions, and some sovereign nation credit guarantees.

The jury is still out on whether a combined London/Paris/Berlin/Brussels approach will be able to counter the moves from Washington. In addition, there may not be a firm resolve for the US to take on Europe having Iran objectives with little substance beyond media talking points.

None of my European, Russian, Chinese, Asian, or Middle Eastern contacts (other than some in the United Arab Emirates, now tied at the hip to the US) regard the American objective of obtaining a "better" nuclear accord with Iran than the JCPOA that Trump departed from last year as achievable. "You cannot scrap an agreement supported by all the other signatories and expect to negotiate a better version," one noted. It's a view widely shared elsewhere.

The predominant opinion sees the US sanction moves as an attempt at regime change in Tehran. "This has zero chance of success," an Iraqi source said. I do not have a single source from among the dozens involved in discussions over the past several weeks who would disagree.

Still, European importers of Iranian crude have been hedging their bets by replacing with volume from other sources. And as I have discussed in past ERCG Intelligence editions, until the suspension of exports via the massive Druzhba pipeline because of contamination, Russia had been expected to be the primary beneficiary of European revisions.

Success Is Insured

The European side of the diplomatic equation will clarify itself as we approach the early July deadline set by the Iranian leadership.

However, the other main battleground has been shaping up more clearly. China is taking a different approach – deciding to take on the US sanctions renewal more directly.

Actually, China's route is one of defiance.

First, China expanded imports of Iranian crude in advance of the sanction renewal announcement to multi-year highs. These were levels much beyond what the domestic market requires short-term, necessitating rising storage expenses

That was then followed by an import hiatus, at least in direct shipments. That has ended, as of the June consignments. The real test here is whether a new network fashioned by the Chinses administration can operate successfully.

That is the second point. US secondary sanctions against shippers, insurers, and financial intermediaries stymied Chinese imports of Iranian crude during the last episode of sanctions. Of course, then the sanctions included moves by EU and the UN paralleling US action.

This time around, the UN had dropped its restrictions following the 2015 signing of JCPOA. Meanwhile, the EU is now opposing Washington.

Over the past year, Beijing has been developing a system using its own tankers (or those that can be leased from others under Chinese guarantees, with some subject to a temporary reflag or reregistration), Chinese banking (supplemented by Singapore-, Doha-, Turkish-, and other-based fiduciary houses), and Chinese insurance.

This last aspect may be the most interesting change since the last sanction battle. Shipping insurance in China is largely covered by one monopoly, an insurer controlled by the main Chinese shipping lines themselves and, thereby, under heavy government leverage.

Last time, in the face of a combined US, EU, UN attack, this Chinese insurer threw in the towel. It told the Chinses tanker companies (i.e., the insurer's own parents) that it could not cover liability. That would require the shippers themselves to shoulder the risk.

Iran attempted to use its own tankers and offer insurance provided by the Iranian national insurance network. But aside from a few short-haul arrangements, that alternative collapsed. Now, China may have had enough time to design a more sustainable domestic alternative than what it had in 2014.

Who Runs Barter-Town?

Third, China retains an advantageous trading situation with Iran, as well as several of Iran’s other oil trading partners. It carries a trade surplus, the current payments account portion of which reduces the effective cost of evading the sanctions.

Much of Iranian oil can be purchased in kind with Chinese goods rather than hard cash. Surpluses with other countries likewise allows a broader connection to barter for oil, potentially evading much of what US secondary sanctions could counter.

Already, barter has been a prominent component in the Chinses approach to importing Iranian oil. That will now almost certainly expand to other importing markets.

Fourth, anecdotal indications are emerging that Chinese national oil company production abroad (Kazakhstan and Iraq in particular) is being employed in contract swaps to facilitate Iranian crude movement into the international market under a “false flag” approach.

In Iraq, this is becoming increasingly paired with Iranian volume being smuggled out as Basra grade crude from southern Iraq. This was a problem in the last sanctions regime as well. Both grades of crude are essentially the same with pipeline access currently in operation across the Shatt al Arab.

These pipes had been intended to move raw material and finished product volume between fields and refineries on both sides of the border. With the heavy Shiite population in southern Iraq, much of this business is effectively controlled by families residing on both sides of the border.

Additionally, broader contract swaps are being orchestrated using those producing countries having heavy debt obligations to Beijing. These combine with loans provided to central governments and national oil companies. In some cases (e.g., Ecuador and Venezuela), these credit lines have resulted in the home governed losing control over its own oil export revenue flow.

Fifth, several Asian and European sources have confirmed that Chinese sovereign credit and central bank protection has been surfacing in other markets on behalf of Iranian exports.

It remains uncertain how expansive these initiatives can become. Beijing does not want to be the global banker or risk underwriter for a massive global attempt to undermine US sanctions. The Chinese domestic economy may be showing signs of slowing down and taking on such a preeminent position in an international operation will put renewed pressure on the domestic currency.

Yuan-A Do Something About It?

This leads to a related, sixth point. When Trump declared a resumption of the sanctions a year ago, debate started circulating over how energetically China wanted to replace dollar-denominated oil trade with trades denominated in yuan.

The primary advantage is seigniorage. This is the advantage occurring when other countries use your currency as the exchange mechanism for trade. The US has benefitted for more than four decades from “petrodollars,” dollars that have to be retained in foreign bank accounts to finance oil trade.

This amounts to an interest-free loan to the US. It allows for an increase in the printing of currency which, since the dollars are not repatriated and circulate domestically, is not inflationary.

But increasing the use of yuan in international oil import-export operations also carries the potential to distort the genuine value of what remains a government controlled (and artificially supported) currency backed by significant amounts of suspect domestic market credit.

All these elements result in an environment less efficient than direct trading, increasing Chinese import costs and reducing Iranian export revenues.

Also, as Beijing focuses on placing restrictions and tariffs on the import of US oil, oil products, and liquified natural gas, the worsening trade war may also impact on how far China is prepared to move in supporting Iran.

Beijing is watching developments in Europe closely to ascertain if there will be a breakthrough in structuring opposition to the US. If there is, there will be a Chinese (and Russian) move to latch on.

And then there is an even bigger issue facing Washington, one involving a rapidly developing national market even more dependent upon Iranian oil imports than is China.

India.

About the Author

Dr. Kent Moors is an internationally recognized expert in oil and natural gas policy, risk management, emerging market economic development, and market risk assessment.

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