

Special Report

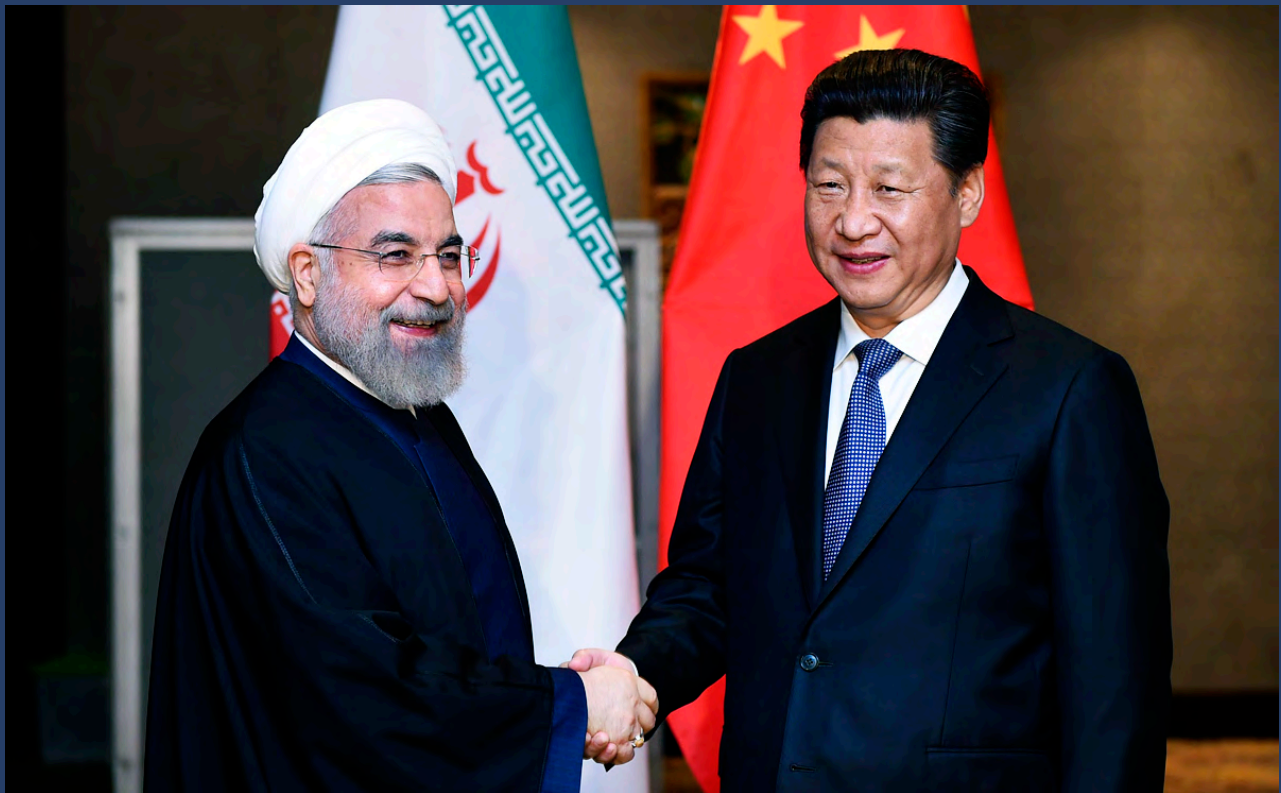
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# Bourse & Bazaar

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## When the Sun Sets in the East

New Dynamics in China-Iran Trade Under Sanctions



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Bourse & Bazaar is a media company that supports "business diplomacy" between Europe and Iran through events, publishing, and research. It is the organizer of the Europe-Iran Forum, the leading economic summit focused on Iran, which has been held in London (2014), Geneva (2015), Zurich (2016, 2017) and Paris (2018). Bourse & Bazaar also supports a global dialogue on Iran trade and investment and has held technical meetings in Tehran, Copenhagen, Stockholm, Moscow, Washington D.C., Milan, Frankfurt and Tokyo over the last two years.

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14 Grays Inn Rd  
London WC1X 8HN  
United Kingdom

## Executive Summary

*A review of trade data from the General Customs Administration of the People's Republic of China shows that China-Iran trade has fallen dramatically in the two months following the reimposition of US secondary sanctions. Chinese exports to Iran have collapsed from about USD 1.2 billion in October 2018 to just USD 400 million in December 2018—a fall of nearly 70 percent. Looking to trade data and recent developments, this paper suggests that China may be abandoning the policy of sustaining trade with Iran in direct contravention of US sanctions, introducing both economic risks in regards to Iran's continued industrialization and political risks in regards to Iran's continued compliance with the JCPOA.*

### I. Iranian Industry, Chinese Parts

Iran's industrialization is import-intensive, relying on foreign machinery and industrial technology. As with peer countries such as Brazil and South Korea, Iran is prone to "structural and technological dependence" which "results in a strong inelasticity of imports to growth, in particular with respect to capital or technology-intensive and intermediate imports." In this way, development is "constrained by the supply of foreign exchange to fund trade deficits, in addition to the broader political economy constraints and challenges involved in processes of late industrialization."<sup>1</sup>

Given the absence of foreign financing, Iran relies entirely on its exports—predominantly oil exports—to generate the foreign exchange necessary to purchase the machinery and equipment that drive industrialization. The direct linkage between oil sales and industrialization has left Iran exposed to considerable political risk, which it has sought to mitigate by balancing its trade relationships between East and West.

Until 2011, the European Union was Iran's primary source of industrial machinery and equipment, exporting USD 7.7 billion in equipment that same year. Chinese exports reached USD 7.2 billion, having grown from just USD 426 million a decade earlier, as Iran's overall demand for industrial equipment grew. However, it was the imposition of financial sanctions in 2012 which spurred China to overtake the EU28 as Iran's primary trading partner in these categories. Chinese suppliers benefited from the fact that China's Bank of Kunlun, owned by state oil giant CNPC, had been nominated to sustain trade with Iran in the face of US secondary sanctions as part of the strategic decision by China to continue purchasing Iranian oil in high volumes.<sup>2</sup> By comparison, European banks proved reluctant to sustain even sanctions-exempt or licensed trade with Iran. Meanwhile, Iran's oil exports to Europe fell precipitously, starving Iran of the foreign exchange revenue necessary to sustain import levels.

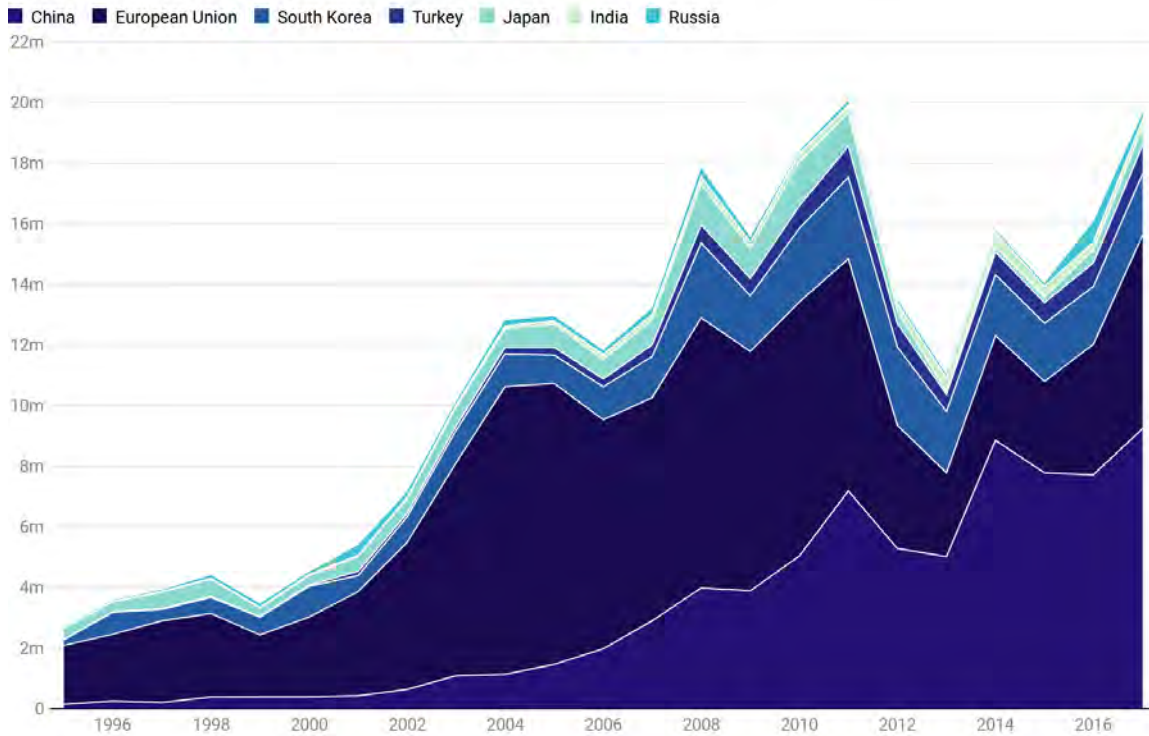
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<sup>1</sup> Fischer, Andrew M. "Debt and Development in Historical Perspective: The External Constraints of Late Industrialization Revisited through South Korea and Brazil." *The World Economy* 41, no. 12 (February 15,

<sup>2</sup> Erdbrink, Thomas. "China Deepens Footprint in Iran After Lifting of Sanctions." *New York Times*, January 24, 2016. <https://www.nytimes.com/2016/01/25/world/middleeast/china-deepens-its-footprint-in-iran-after-lifting-of-sanctions.html>

**Figure 1: Exporters of Machinery and Transport Equipment to Iran (UNCTAD)**

USD Thousands - SITC Category 7



China’s emergence as Iran’s foremost trade partner gave rise to a new discourse of economic planning in Iran. Both within government and the private sector, the challenges posed by Western-led sanctions gave rise to the idea that Iran should turn to the East in order to meet its development targets. The ascendencies of China and India as major economic powers, meant they could now provide the same technological and financial support as Western countries, but without making “economic relations conditional on ‘acceptable’ political processes or behavior.”<sup>3</sup>

The desire to balance East and West can be seen in the Iranian approach to foreign direct investment following the implementation of the JCPOA, which brought broad sanctions relief for Iran. Across sectors, Iranian state and private sector companies pursued both European and Chinese partners, while also seeking to involve Indian, Japanese, and South Korean firms. When France’s Total was awarded the first major oil and gas contract in 2016, it was as part of a consortium including China’s CNPC. Italy’s Ferrovie was contracted to engineer a high speed railway between Tehran and Isfahan which was to be built by the China Railway Engineering Corp.<sup>4</sup> Iranian state-owned firms Iran Khodro and SAIPA restarted partnerships with European automakers Renault and PSA Peugeot Citroen, and truck makers Volvo and Daimler, but also sought to expand the presence of

<sup>3</sup> Tabatabai, Ariane, and Dina Esfandiary. *Triple-Axis: China, Russia, Iran and Power Politics*. I. B. Tauris, 2018. (111)

<sup>4</sup> Beindich, Mark, and Parisa Hafezi. "China Pushing Billions into Iranian Economy as Western Firms Stall." *Reuters*, November 30, 2017. <https://uk.reuters.com/article/uk-iran-nuclear-china/china-pushing-billions-into-iranian-economy-as-western-firms-stall-idUKKBN1DU2A8>.

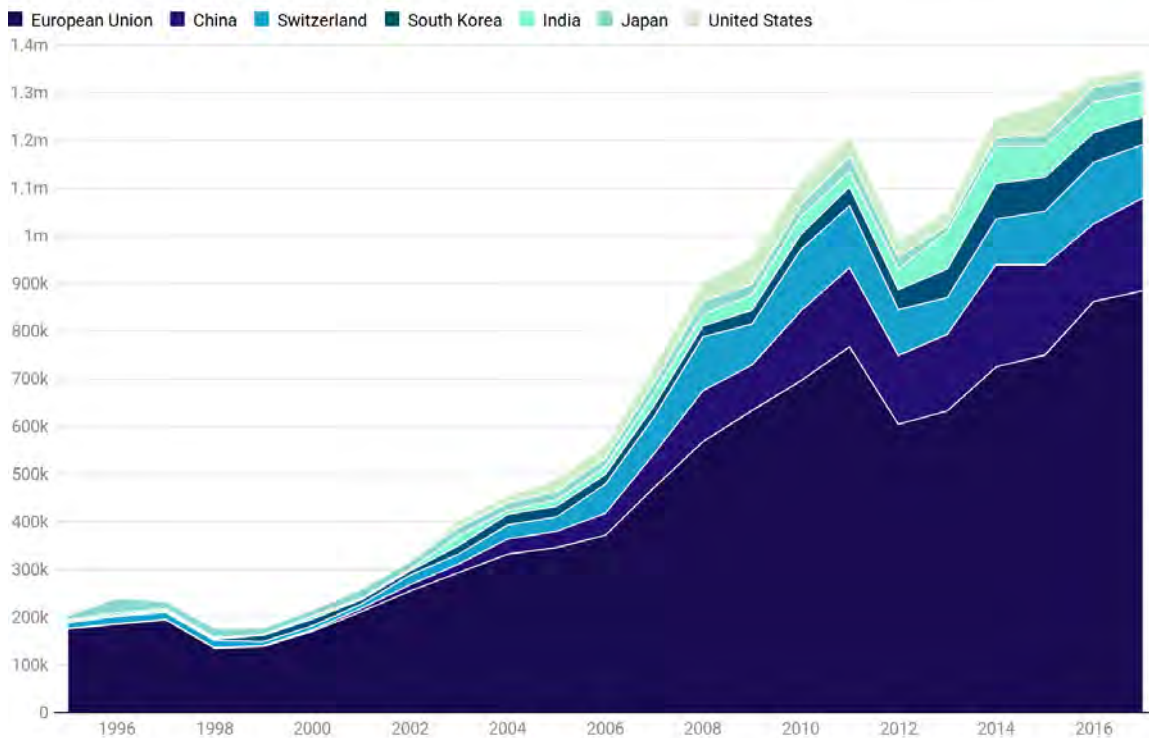
Chinese players such as Chery and Dongfeng that had taken market share from the Europeans in the sanctions period.

Of course, there remain several areas where balancing trade and investment between Europe and China is impossible. Iran imports nearly USD 900 million in medicine and medical devices from the EU28 each year. Chinese exports amount to just under USD 200 million in the same categories. Europe’s edge in technology and intellectual property in pharmaceutical products and medical devices means that substitutes cannot be sourced from China.

Add to this the fact that European brands hold stronger resonance with Iranian consumers and that European multinationals had made equity investments in local manufacturing capacity, whereas Chinese competitors have not, and it is clear that Iran could not reasonably seek to eliminate its dependence on trade with Europe as a means to de-risk. The only viable strategy has been diversification. But in pursuing diversification, it seems that Iran may have overlooked the extent to which its trade ties with China could prove as politically exposed and contingent as those with Europe.

**Figure 2: Exports of Medicine and Medical Devices to Iran (UNCTAD)**

USD Thousands, SITC Categories 541, 774, 872



## II. Sanctions Return

In May, President Trump announced that the United States was withdrawing from the JCPOA, setting in motion the reimposition of US secondary sanctions on Iran, which returned in full in November of that year. Commercial actors in Europe had feared that

Trump would make such a move and trade with Iran had been subdued from the time of his election. But the reimposition of sanctions created new barriers to trade. European leaders quickly realized their predicament. Unfettered trade and investment with Iran was a central part of the quid-pro-quo underpinning the nuclear deal—US secondary sanctions put the whole deal at risk. Moreover, European leaders perceived a more general threat from Trump towards the integrity of multilateral agreements and the political and economic sovereignty of Europe in entering such agreements.

Several steps were taken to try and reaffirm the European commitment to the JCPOA and provide confidence to business increasingly wary of sustaining commercial ties with Iran. First, the European Union updated the blocking regulation, a largely symbolic law which makes it illegal for European companies to comply with extraterritorial sanctions. Second, the governments of France, Germany, and the United Kingdom began developing a special purpose vehicle (SPV), a mechanism intended to help sustain European trade with Iran by reducing the need for banks to facilitate cross-border transactions.

These two acts required significant political capital, not only from European governments which needed to assert a policy in the face of a breakdown of the transatlantic relationship, but also from the Iranian leadership, which needed to exercise considerable patience as the machinery of Europe sought to get ahead of the sanctions impact. But as this political capital was spent, far less attention was given to developments in China-Iran trade, in part because of reassuring statements from Chinese authorities.

In October, shortly before US sanctions came back into force, Chinese foreign ministry spokesperson Hua Chunying told reporters that “China always opposes the unilateral sanction and long-arm jurisdiction. China's normal cooperation with Iran under the framework of the international law is reasonable, legitimate and legal and it should be respected and upheld.” She reiterated strong support for the JCPOA.<sup>5</sup>

### III. Trade Impact

Meanwhile, commercial actors were hearing a different message. In the months following Trump’s withdrawal from the JCPOA, rumors began to swirl in Iran that China’s Bank of Kunlun was reconsidering its Iran business. Trade with Chinese partners appeared to be slowing. The first clear warning sign came in September, when the value of Chinese imports of Iranian oil fell to USD 1.16 billion from USD 1.78 billion in the previous month. Imports fell further in October to just USD 628 million, before rebounding to USD 925 million in November and USD 1.06 billion in December. Just a few days before the reimposition of secondary sanctions on November 4, China was among eight countries that received a Significant Reduction Exemption (SRE) from the US government which permitted the continued importation of Iranian oil if the proceeds of Iran’s sales were exclusively used for the purchase of humanitarian goods such as foodstuffs and medicine.

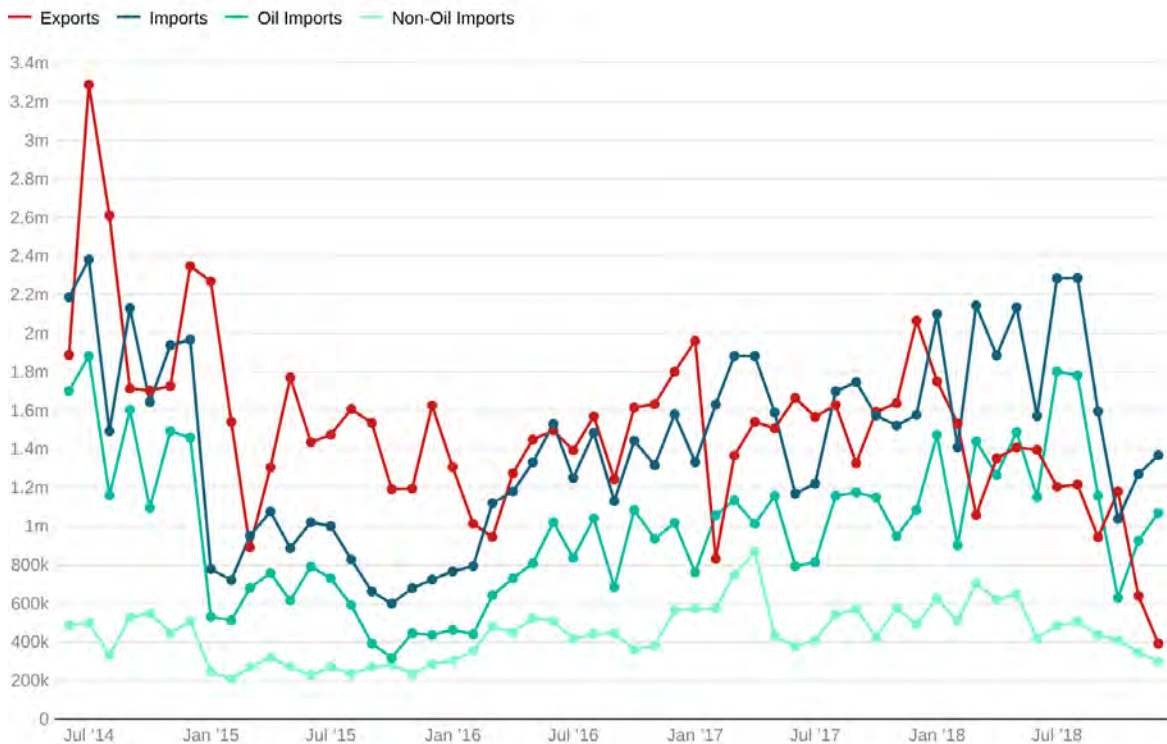
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<sup>5</sup> " Foreign Ministry Spokesperson Hua Chunying's Regular Press Conference." Ministry of Foreign Affairs of the People’s Republic of China. October 28, 2018.  
[https://www.fmprc.gov.cn/mfa\\_eng/xwfw\\_665399/s2510\\_665401/t1606828.shtml](https://www.fmprc.gov.cn/mfa_eng/xwfw_665399/s2510_665401/t1606828.shtml)



**Figure 3: China-Iran Bilateral Trade (GACC)**

USD Thousands, Oil Imports Based on HS 27 Category



The decision to pursue an SRE presaged an announcement from Bank of Kunlun which confirmed the rumours of a reconsideration. The bank informed clients it was putting all Iran-related business on hold pending a change in policy, effectively shutting the main financial channels through which the majority of China-Iran trade was conducted.<sup>6</sup> In December, it was announced that the bank would only process humanitarian trade, in a move consistent with the terms of the SRE, meaning that Iranian importers of Chinese machinery and other “sanctionable” goods could no longer pay for orders.<sup>7</sup>

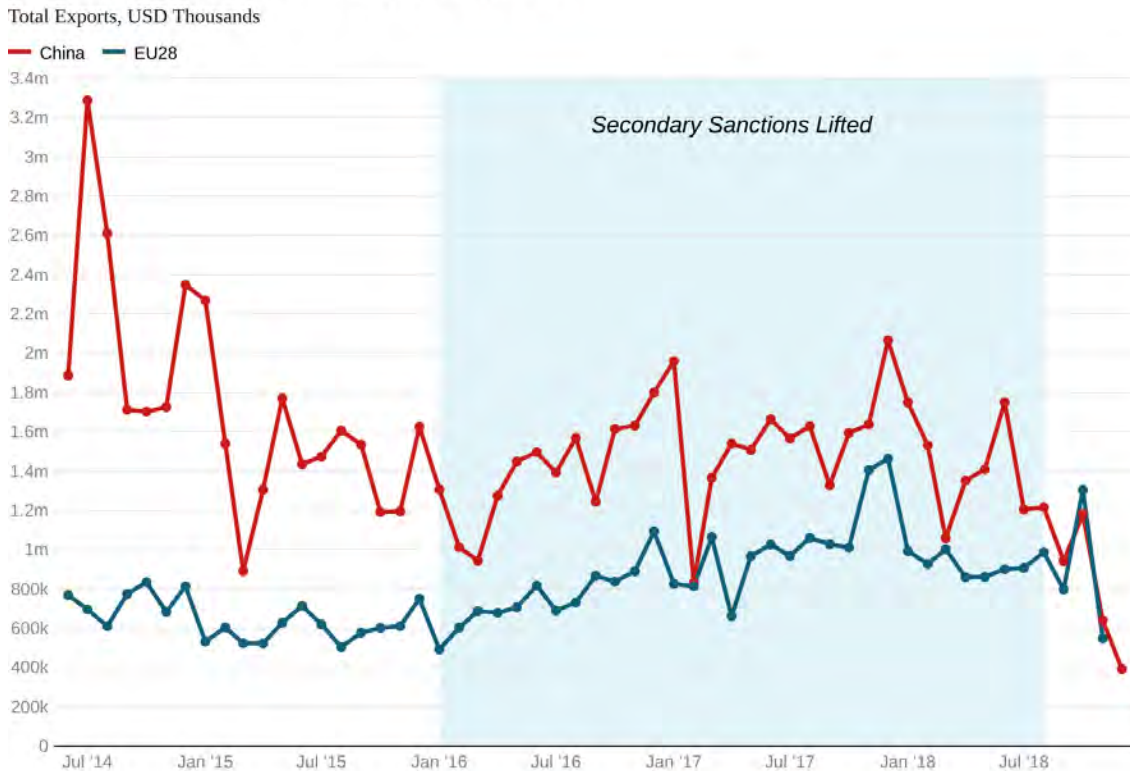
The significance of these announcements was quickly understood by Iranian industrialists, who warned that Iran had just a few months of inventory remaining until the interruptions in the supply of inputs and parts would have a direct knock-on effect on industrial output. As of yet, no alternative banking channel has been identified by Iranian commercial actors nor nominated by the Chinese government. An analysis of the trade data for the months leading-up to the return of secondary sanctions substantiates fears. October 2018 was the first month in many years in which EU28 exports to Iran exceeded those from China, in part because of the bumper effect of European suppliers trying to fulfill orders before the reimposition of sanctions on November 4. With sanctions in place, European exports fell as expected to just over USD 550 million from USD 1.3 billion.

<sup>6</sup> Motamedi, Maziar. "China Unexpectedly Gambles on European Mechanism to Sustain Iran Trade." *Bourse & Bazaar*, November 1, 2018. <https://www.bourseandbazaar.com/articles/2018/10/31/china-unexpectedly-gambles-on-european-spv-to-sustain-iran-trade>.

<sup>7</sup> Motamedi, Maziar. "Policy Change at China's Bank of Kunlun Cuts Iran Sanctions Lifeline." *Bourse & Bazaar*, January 2, 2019. <https://www.bourseandbazaar.com/articles/2019/1/2/policy-change-at-chinas-bank-of-kunlun-cuts-sanctions-lifeline-for-iranian-industry>.

More surprisingly, Chinese exports also fell dramatically, down to USD 639 million in November, before falling further to just USD 391 million, the lowest monthly level in at least five years based on the available data. Exports have fallen by a staggering 68 percent since October. When considering that some of the cargoes tabulated by China’s customs administration may have been paid for in advance, it is likely that the total value of Chinese exports paid for in the month of December is even lower. Though sanctions hit late in 2018, total exports were USD 1.4 billion, a level last seen in 2013.

**Figure 4: Chinese and EU28 Exports to Iran, Comparative (EUROSTAT, GACC)**



The volume of Chinese exports is necessarily linked to Chinese imports from Iran, especially imports of crude oil. Inflows and outflows are more directly linked in the Chinese context than in the European context. Whereas the changes in export and import volumes in Europe reflect the decisions of two independent sets of commercial actors, given the state-led disposition of the Chinese economy and the centralization of payments in a single banking channel, changes in trade flows reflect centralized changes in policy. Put more simply, Chinese refiners will import less crude under new terms for the same reason that Bank of Kunlun will facilitate payments for fewer exports—a change in government policy.

## IV. Changing Policy

Tellingly, the rebound in oil imports in December, consistent with the operationalization of the SRE, was not accompanied by a rebound in exports to Iran, but rather a further decline. This suggests that the banking difficulties stemming from the change of policy at



Bank of Kunlun— not the fall in oil exports—are the likely cause for the fall Chinese exports to Iran. Since 2014, on average, Chinese exports to Iran have tended to exceed imports by of USD 7.5 million per month. Put another way, while there is high volatility month-to-month, Iran tended to spend more than it earns in China in a given year, suggesting strong demand for Chinese imports. In 2018, this pattern reversed. Chinese imports have exceeded exports by an average of USD 584 million per month, driven in part by bumper purchases of Iranian crude this summer at a time when export totals had begun their now accelerating decline. Why are Iran’s earnings going unspent?

While the trade data clearly demonstrates a new dynamic in China-Iran trade under sanctions, it is not yet conclusive as to whether these restrictions primarily reflect the decision to limit commerce to humanitarian trade. In the ten months leading up to the reimposition of sanctions in November, Chinese exports of machinery and mechanical appliances accounted for a monthly average of 32 percent of total export volume. In November and December, that proportion remained consistent at 37 percent, despite the significant fall in total export values.

However, parts and equipment for which prepayment was arranged may account for some of this total. It is also notable that exports of vehicles and transportation equipment—one of the largest export categories—fell as a proportion of total exports from a monthly average of 19 percent to just 3.5 percent in the last two months, a fall consistent with a restriction on goods that would be considered sanctionable under US secondary sanctions. Anecdotally, the data does support growing concerns among Iranian industrialists that the breakdown in China-Iran trade is leading to shortages in key manufacturing inputs. Until data is available for the first quarter of 2019, it is not possible to point to a clear trend.

Nonetheless, if these early figures do reflect change in Chinese policy, Iranian and European stakeholders will have been caught by surprise. On face, the significant fall in China-Iran trade appears inconsistent with the Chinese foreign ministry’s assurances that China remains committed to its commercial relationship with Iran and its opposition to the extraterritorial nature of US sanctions. Such statements seemed to confirm the longstanding consensus that China’s strategic interest would see it protect Iran against “US-led efforts to isolate a lesser non-Western aligned power.”<sup>8</sup> But the decision to secure an SRE heralded a new reluctance to directly contravene US secondary sanctions. There are several possible factors behind this reluctance:

### *US-China Trade War*

The roiling trade war led by the Trump administration has forced China to enter into complex negotiations over its trade deficit with the United States. The arrest of Huawei CFO Meng Wanzhou for her role in alleged Iran sanctions violations demonstrated the risks posed should Iran-related disputes spillover into the trade war negotiation.<sup>9</sup> In the context of negotiations, sacrificing trade with Iran would be

<sup>8</sup> Tabatabai, Ariane, and Dina Estandiary. *Triple-Axis: China, Russia, Iran and Power Politics*. I. B. Tauris, 2018. (80)

<sup>9</sup> Hille, Katherine and Louise Lucas. "Huawei Executive’s Arrest Threatens US-China Trade Talks." *Financial Times*, December 6, 2018. <https://www.ft.com/content/a1f89c74-f93e-11e8-af46-2022a0b02a6c>.

an inexpensive concession for China which would nonetheless prove meaningful to the Trump administration's campaign to enact "maximum pressure" on Iran. Some evidence for such an approach can be seen in the recent news that Sinopec has proposed a new USD 3 billion investment in its Iranian oilfield, recalling the bullish investments made in the previous sanctions period, but that this time the company has deferentially "informed the State Department about its Iran oil business."<sup>10</sup>

#### *Waiting for Europe to Lead*

Leaked diplomatic cables published by the *New York Times* reveal that during a working lunch at the EU-China Summit in July, Donald Tusk, president of the European Council, asked Chinese officials whether they "would consider financial mechanisms to mitigate secondary sanctions" placed on Iran by the United States. Chinese Premier Li Keqiang responded that China would "not act unilaterally" in this regard, according to a European summary of the meeting.<sup>11</sup> Given surprising European persistence in withstanding US pressure, and with the special purpose vehicle (SPV) for Iran trade forthcoming, it may be that China will now reevaluate its own response to US sanctions.

#### *Pending FATF Mutual Review*

The Financial Action Task Force, a global standards-setting body, is currently underaking a "mutual review" of Chinese standards in the areas of anti-money laundering (AML) and combatting the financing of terrorism (CFT). The decision to downgrade banking ties with Iran within the period of review may reflect a belief that limiting exposure to a financial system that the FATF considers marked by significant AML/CFT risks will lead to a more favorable assesment, particularly at a time when the United States holds the rotating presidency of the body.

#### *Concerns Among Chinese Companies*

Having grown in global profile over the last decade, Chinese suppliers are increasingly concerned about the sanctions and reputational risks posed by business with Iran. One chief executive of an Iranian industrial group that conducts significant business with Chinese firms, who requested anonymity given commercial sensitivities, relayed his large Chinese suppliers do not "want to be in export list, which is where US eyes are looking" because of a pervading fear that

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<sup>10</sup> Faucon, Benoit. "China Offers Iran \$3 Billion Oil-Field Deal as Europe Halts Iranian Crude Purchases ." *Wall Street Journal* January 17, 2019. <https://www.wsj.com/articles/china-offers-iran-3-billion-oil-field-deal-as-europe-halts-iranian-crude-purchases-11547743480>

<sup>11</sup> Sanger, David and Steven Erlanger. "Hacked European Cables Reveal a World of Anxiety About Trump, Russia and Iran." *New York Times* December 18, 2018. <https://int.nyt.com/data/documenthelper/540-read-the-diplomatic-cables/27bc7c9cfe024869481d/optimized/full.pdf>

“the United States will be making example cases,” targeting companies still trading with Iran to create a “system-wide scare.”<sup>12</sup>

### *New Geopolitical Landscape*

As evidenced by President Hassan Rouhani’s recent visit to India and the launch of Indian operation of Iran’s Chabahar port, Iran has been deepening political and economic ties with India. Meanwhile, Chinese investment in Pakistan has intensified, including around China’s own investment in the Gawadar port and arms sales to Pakistan’s military.<sup>13</sup> Pakistan may displace Iran as China’s preferred export market in West Asia, particularly if Pakistan remains open to military and infrastructural involvements that Iran would either reject as a violation of sovereignty or seek to counterbalance with European, Russian, or Indian projects. Iran has yet to feature highly in China’s flagship Belt and Road initiative, reducing the political impetus to protect economic ties in the face of US pressure.

Whatever the primary reason, if China remains unwilling or unable to sustain trade ties with Iran in the face of US sanctions, the consequences will prove significant. While pressures were expected in Europe-Iran trade, the addition of pressures stemming from China will further weaken Iran’s economy. The fall in exports of food, medicine, and consumer goods from Europe will contribute to inflation, while the fall in exports of machinery and equipment from China will lead to production slowdowns and layoffs in the manufacturing sector. A recent survey of members conducted by the Tehran Chamber of Commerce identified that 72 percent of enterprises expect to business conditions will worsen for their firm over the coming year.<sup>14</sup>

Inflation and unemployment will be the pincers that squeeze Iranian households. But, the political impact of industrial layoffs may prove more significant than the less visible economic pains caused by inflation, itself driven in part by the rising cost of imports and the fall in Iran’s foreign exchange revenues. While people can change their consumer behaviors in response to rising prices, the loss of income from unemployment is far more devastating and destabilizing. To the extent a change in policy in Beijing will contribute to layoffs across Iran in the coming months, the trajectory of China-Iran trade may prove more consequential than Europe-Iran trade for Iran’s ability to remain in the JCPOA. If the nuclear deal collapses due to extraordinary economic pressures in Iran, China may be to blame.

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<sup>12</sup> Motamedi, Maziar. "Policy Change at China’s Bank of Kunlun Cuts Iran Sanctions Lifeline." *Bourse & Bazaar*, January 2, 2019. <https://www.bourseandbazaar.com/articles/2019/1/2/policy-change-at-chinas-bank-of-kunlun-cuts-sanctions-lifeline-for-iranian-industry>.

<sup>13</sup> Abi-Habib, Maria. "China’s ‘Belt and Road’ Plan in Pakistan Takes a Military Turn." *New York Times* December 19, 2018. <https://www.nytimes.com/2018/12/19/world/asia/pakistan-china-belt-road-military.html>

<sup>14</sup> “The private sector is not optimistic about the future,” *Tehran Chamber of Commerce and Industry*, January 15, 2018. [http://tccim.ir/images/TccimPaper/AyandeNegar\\_77.pdf](http://tccim.ir/images/TccimPaper/AyandeNegar_77.pdf).

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For more information contact:

Esfandyar Batmanghelidj  
yar@bourseandbazaar.com

14 Grays Inn Rd,  
London WC1X 8HN  
United Kingdom