For more than three decades, the United States has tried to persuade the international community to counter the threat posed by Iran's Islamic regime. The results have often been underwhelming, with even Washington's closest allies resisting tough measures against Iran because of strategic considerations and commercial interests.

Recently, however, that landscape has changed. Last June, the United Nations Security Council penalized Tehran for failing to suspend its uranium-enrichment program by adopting strict new sanctions, including an arms embargo and tough restrictions on Iranian banks and the Revolutionary Guard Corps. Resolution 1929 also paved the way for individual states to adopt even more stringent penalties. Australia, Canada, Japan, Norway, South Korea, and the European Union implemented unprecedented curbs on investment in Iran. The U.S. Congress passed new sanctions against any company selling gasoline to Iran or investing in Iran's refining capacity. Collectively, these measures have squeezed Iran's economy.

Yet one uncertainty still looms large: China's commitment to such policies. Driven by economic interests, as well as sympathy for Iran's grievances, China is the only major player still active in the Iranian oil patch. Whereas firms from most other countries have retreated due to international pressure and Iran's unfavorable business climate, China and its companies adhere only to the letter of Resolution 1929, which contains no explicit restrictions on energy investment or trade. China has thus emerged as the linchpin of the international sanctions regime against Iran and, by extension, of the effort to forestall Iran from acquiring a nuclear capability.
This situation presents U.S. policymakers with tough choices. Even as the U.S. political climate has turned more rancorous toward both Iran and China, the Obama administration will need to build a more positive partnership with China on the Iran issue while attempting to stabilize the broader bilateral relationship. One option is to exploit the underlying fissures that exist between Beijing and Tehran despite their strong ideological and commercial links.

THE CHINESE EXCEPTION

The sanctions regime targeting Iran is now more muscular than ever, but the gap between the UN Security Council measures and the much harsher sanctions adopted by the United States and other countries has created an uneven playing field in Iran. In contrast to virtually all major Western governments, Beijing still allows its companies to do business there. However, some activities considered acceptable by Beijing are punishable under the new, extraterritorial U.S. sanctions.

Two likely flash points concern Chinese investments to recover and produce Iran's oil and natural gas (upstream activities) and China's sale of gasoline to Iran. First, Tehran is likely to continue to seek upstream investments from China's national oil companies (NOCs) to compensate for the departure of other firms. Chinese companies have moved carefully so far because of the tough operating environment and diplomatic sensitivities, but the prospect of gaining a larger position in Iran's upstream market will prove increasingly tempting: it is a rare opportunity to secure huge fields that might have gone to Western companies in the absence of sanctions. These NOCs, which are powerful political actors, may try to convince Beijing that gaining access to Iran's hydrocarbon reserves is worth the risk of U.S. sanctions against Chinese companies. Second, Chinese oil traders may want to continue supplying gasoline to Iran even as many European companies voluntarily stop selling in order to avoid new penalties on their business dealings in the United States. The incentives of Chinese firms are both financial (Tehran reportedly buys the gasoline at a 25 percent premium above the market rate) and political (Beijing opposes U.S. sanctions as extraterritorial legislation that harms the Iranian people).

China's posture toward Iran and the U.S. response will have implications for both the global energy business and international diplomacy. If China refuses to stop its upstream investments or gasoline sales, the Obama administration will have to choose between applying U.S. sanctions to Chinese firms and waiving them. Either move would be costly, but the price of inaction might be higher. With Chinese companies expanding their stakes in Iran, competitors that have voluntarily pulled out might return, and others might start pressuring their governments to relax the sanctions or might skirt them altogether by creeping back into Iran.
Washington must balance persuasive and dissuasive tools in order to strengthen Beijing's cooperation on Iran and continue to work with it on other priorities, such as North Korea, climate change, and reforming the international economic order. Sanctioning Chinese companies would only complicate bilateral relations, heightening the tensions that grew during 2010. Like its predecessors, the Obama administration has thus far declined to enforce a 1996 measure penalizing third-country companies that invest in Iran's energy sector. However, this wink-and-nod approach might not satisfy congressional hawks seeking to raise the cost of defiance for Tehran. The Republican Party's resurgence in Congress in the November 2010 elections will put pressure on the White House to turn up the heat on both Iran and China. Congress can make its preferences felt through tough rhetoric, hearings, investigations, and reporting requirements. Proposals for new penalties against Tehran, including sanctions against any company that purchases Iranian crude oil, are already circulating on Capitol Hill.

Ultimately, the Obama administration will have to find a middle ground. It must avoid slapping sanctions on U.S. allies and fragmenting the hard-won international coalition on Iran while maintaining robust economic pressure on Tehran and enhancing the credibility of U.S. policy. Outreach toward Beijing should thus reinforce the intrinsic limitations of Chinese-Iranian cooperation and reduce the chances of a confrontation between Washington and Beijing over Iran.

DANGEROUS LIAISONS

In order to secure Beijing's cooperation, Washington must appreciate the full scope of the Chinese-Iranian relationship. China is the world's second-largest oil importer. Iran's oil and natural gas reserves rank among the world's largest, making the country an attractive destination for China's NOCs, which are increasingly looking for opportunities abroad. Already, Iran is China's third-largest supplier of crude oil.

China's interest in Iran's reserves is matched by Tehran's own exigencies. Oil production in Iran remains well below pre-1979 levels, massive offshore gas reserves remain underdeveloped, and vast subsidies on fuel products have sent domestic energy consumption skyrocketing, leaving the country reliant on gasoline imports. In the 1990s, Tehran began courting foreign oil companies, but constitutional limitations on foreign ownership, uncompetitive rates of return, and a tendency to renegotiate agreements have eroded Iran's appeal as a destination for international capital. Sanctions have also precluded Iran from accessing the foreign technology needed to liquefy natural gas, limiting its gas exports. Chinese companies thus bring much-needed foreign capital to Iran's energy industry. China has also sold gasoline to Iran even as other suppliers have had to halt their sales.
Oil may grease the wheels, but the Chinese-Iranian relationship transcends energy. Robust activity in the arms trade, mining, transportation, power generation, and consumer goods markets -- including those for electronics, auto parts, toys, and even Islamic headscarves - has helped make China one of Iran's leading trading partners, second only to the reexport hub of Dubai.

And Chinese-Iranian cooperation goes beyond mere economic expedience. It has political appeal for leaders in Tehran, validating their claims that sanctions do not affect Iran and that Iran does not need the West. Chinese and Iranian oil companies have signed agreements at politically opportune times for Tehran. For example, in late 2004, just as Washington was pressing for -- and Beijing was opposing -- referring the Iranian nuclear file to the UN Security Council, the Chinese oil company Sinopec and the National Iranian Oil Company drafted a memorandum of understanding for the development of the massive Yadavaran oil field.

More generally, the relationship is grounded in a shared worldview that transcends obvious ideological differences. Iran's leadership professes to admire China's rapid economic development and its disinclination to meddle in other states' internal affairs. Meanwhile, Beijing recognizes Iran as a fellow heir to a great civilization and as the heavyweight of the Middle East. And it values Tehran's overall lack of interest in inciting the restive Muslim population of Xinjiang.

Both Beijing and Tehran distrust Washington and find the West arrogant. Tehran resents the economic sanctions and invokes them in its historical narrative of persecution; Beijing regards them as an ineffective diplomatic tool. Iranian leaders have expounded at length about the West's plot to subjugate China. This conspiracy theory resonates with some Chinese, who suspect that Washington wants to push China to assume greater international responsibility in order to entangle it in problems beyond its borders and thereby constrain its reemergence.

THE TIES THAT BIND

Yet ties between China and Iran are hardly ironclad. Beijing takes a more cautious approach to Iran than sensational press headlines and political rhetoric in the United States often imply. The amount of money that China's NOCs have committed to projects in Iran, let alone actually invested, is considerably smaller than the $100-$120 billion frequently cited. Chinese firms are not entirely immune to the checks that have hindered other companies. They have also been deliberately prudent in finalizing their investments. Their strategy is to negotiate agreements but delay major spending in the hope of securing access
to Iran's resources over the long term while minimizing the immediate risks of taking on legal and financial commitments in an unpredictable environment.

Moreover, Beijing is wary of an outright breach with Washington, its most important bilateral relationship. Circumspection toward Tehran partially offsets Beijing's mercantilist considerations. A case in point: Chinese crude oil imports from Iran dropped by 35 percent during the first half of 2010. Chinese oil traders blame pricing issues, but the decline notably coincided with Washington's efforts to get Beijing to support UN sanctions, which included pressuring the Saudi government to guarantee oil supplies to China.

Iranians, for their part, are much more ambivalent about China's economic activities in Iran than is often understood by outsiders. Tehran appreciates that Chinese investments bolster Iran's aging oil sector, and it trumpets them -- frequently in exaggerated terms -- as a way to undermine international opposition and attract other investors. Beyond the headlines, however, China has become an all-purpose scapegoat in Iran's fractious politics. Politicians and clerics have denounced the awarding of contracts to countries that backed the UN sanctions. To express its displeasure with China's support for the latest sanctions, the Iranian parliament's national security committee pledged to launch an inquiry into Chinese-Iranian relations. Soon after the UN Security Council resolution was passed last June, Tehran even briefly agitated about the plight of China's Muslim population.

Antipathy toward China's increasing market dominance is growing among Iran's influential merchant community. Iranians have long overindulged an appetite for imported goods, and Chinese exporters have been the primary beneficiaries of Iran's rising oil revenues over the last decade. The Iranian media regularly complain that China is price gouging, that its materials are inferior, and that cheap Chinese imports are driving Iran's small industries out of business. Such rhetoric could easily aggravate bilateral relations, particularly as Tehran tries to restrict import spending, including by banning 170 "low-quality" products, nearly all Chinese, that it claims are "beneath the dignity" of Iranian consumers.

THE INDISPENSABLE PARTNER

But the Obama administration cannot afford to rely on the self-limiting features of the Chinese-Iranian relationship. China and Iran have powerful incentives to further expand bilateral trade and investment, and partisan acrimony in Washington will almost surely produce greater scrutiny of China's economic ties to Iran. Without a strategy, the United States could fall into an unintended trade war with China or see relations between the two countries deteriorate.
Sensible steps can minimize the prospects for conflict. The first is to deepen cooperation with Beijing regarding Iran, especially on the nuclear issue. Washington has long treated Beijing as an ancillary dimension of its Iran diplomacy, subordinating China's views to the more immediate challenge of generating support for sanctions against Tehran from Europe and Russia. But with Beijing's support becoming more crucial to the efficacy of the sanctions, China must now move to center stage in the United States' diplomacy regarding Iran.

This will require elevating the bilateral diplomatic dialogue by creating a sustained high-level mechanism for coordinating the United States' and China's approaches to Iran. Washington needs to remind Beijing that actions to constrain Iran's nuclear program support China's own interest in keeping oil supplies steady and prices stable. The Obama administration must also help Beijing appreciate that without an effective sanctions regime, the risks of a military strike by Israel against Iran would rise -- another source of price volatility. One model for such an effort is Washington's handling of the Iran issue with Moscow. For more than a decade, Washington invested in a high-level dialogue, frequent bilateral consultations, and intelligence sharing. The payoff has been greater trust and cooperation and a shift in Russia's position on Iran from obstructionism to cordial collaboration.

Another step will be to ensure clear communication with Beijing about Washington's expectations regarding the sanctions. This should include both a quiet bilateral dialogue and public statements announcing the limits of Washington's forbearance. One obvious point to make is that penalties might be applied to firms that take over projects that other companies have abandoned because of the sanctions. The senior State Department official Robert Einhorn has already warned China's NOCs not to replace departing European and Japanese oil companies, as this could undermine international efforts to isolate Iran by prompting the companies that voluntarily pulled out of Iran to reinvest there.

Beijing might be willing to refrain from making new upstream investments in exchange for being allowed to maintain its existing ones. Forgoing new deals would be costly for China's NOCs, but the tradeoff would mean the recognition of China's energy interests in Iran, something Beijing has hoped to get from Washington. It would also be more palatable to China's NOCs than withdrawing from Iran altogether. And it would conserve Beijing's political capital with Iran's leaders, who care more about hyping their purported invulnerability to sanctions than wisely managing their country's national resources.

Washington should also encourage China to signal its willingness to get tough on Iran. Russia's recent announcement that it was suspending the planned sale of an air defense system to Tehran exposed the extent of Iran's international isolation both to its leaders and
to its people. China should likewise signal to Iran's decision-makers that Beijing is prepared to make its investments contingent on Tehran's willingness to cooperate with the international community on its nuclear program.

Just as important as the diplomatic dimension will be the Obama administration's efforts at home. First, the White House should encourage China's NOCs to invest in the United States instead of Iran. Capitol Hill's furious reaction helped derail the 2005 bid by the Chinese energy giant CNOOC to buy the California-based Unocal. The Obama administration and Congress must work closely to prevent such a scenario from unfolding again, particularly since China is a convenient scapegoat for U.S. legislators. It is promising that CNOOC recently was able to purchase a 33.3 percent stake in the American gas company Chesapeake Energy's Eagle Ford Shale project in Texas. Ensuring that more such projects proceed without domestic backlash would emphasize to Beijing the potential benefits of cooperating with Washington on its Iran policy.

The White House must also play an active defense with Congress. China would likely interpret legislation penalizing countries that purchase crude oil from Iran -- an initiative under consideration today -- as a threat to the security of its oil supply. And Congress' continued attacks on China's presence in Iran could hurt cooperation between Beijing and Washington. The executive branch must do more to persuade a skeptical Congress that pouncing on China does not help -- and could easily impede -- U.S. efforts to prevent Iran from achieving a nuclear capability.

Finally, the United States and its allies must maintain a united front in their dealings with Tehran. The UN sanctions passed last June proved that Beijing can be persuaded to support pressuring Tehran; China does not want to be isolated on major global issues. Building such a consensus is arguably more difficult today because of the deterioration in the U.S.-Chinese relationship that occurred in 2010. But it is also more important: Washington must fully appreciate the indispensable role that China will play on the Iran issue. Beijing's decisions will shape not only the long-term viability of the multilateral sanctions regime but also the interests and options of the increasingly isolated and paranoid Iranian leadership. If Washington wants to meet the challenges posed by Tehran, it must promote Beijing from a silent, subordinate partner to a vigorous ally.