

INSTEX, a Game Changer?

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Abstract:

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In July 2015, Iran and the P5+1 (China, France, Germany, Russia, the United Kingdom and the United States) concluded the Joint Comprehensive Plan of Action (JCPOA). Iran agreed to restrictions on its nuclear programme in exchange for relief from economic sanctions. The Islamic Republic of Iran announced on 5 January 2020 that they were no longer bound by any of the restrictions laid out in the Agreement, particularly on its enrichment programme. However, the first blow to the JCPOA came in May 2018 when the United States (US) announced its withdrawal from the deal and reinstated unilateral sanctions on Iran. These sanctions have an extraterritorial reach, which means they apply to non-US subjects.¹ To mitigate the effects of sanctions on the Iranian economy, France, Germany and the United Kingdom (E3) announced on 31 January 2019, the establishment of the Instrument in Support of Trade Exchanges (INSTEX), “aimed at facilitating legitimate trade between European economic operators and Iran”.² A year after its creation, there is little information about how the instrument functions, how much it has achieved and its future. This paper is based on a series of interviews with Iranian, German and European Union (EU) officials who all wished to remain anonymous, as well as Richard Nephew, a Senior Research Scholar at Columbia University and former US National Security Council director for Iran. These interviews were conducted prior to the 5 January 2020 Iran’s announcement and the 14 January statement by E3 triggering the Dispute Resolution Mechanism under the JCPOA. This paper aims to (1) get a better understanding of how and why INSTEX was created and how it functions; (2) assess the success of INSTEX and understand its deficiencies; and (3) discuss possible adjustments to the mechanism.

¹ European Parliament (2018) ‘Extraterritoriality of US Laws’,
http://www.europarl.europa.eu/doceo/document/E-8-2018-006496_EN.html

² Le Drian, J-Y.; Maas, H.; Hunt, J. (2019) ‘Joint Statement on the Creation of INSTEX, the Special Purpose Vehicle Aimed at Facilitating Legitimate Trade with Iran in the Framework of the Efforts to Preserve the Joint Comprehensive Plan of Action’, Ministère de l’Europe et des Affaires Etrangères,
<https://www.diplomatie.gouv.fr/en/country-files/iran/events/article/joint-statement-on-the-creation-of-instex-the-special-purpose-vehicle-aimed-at>

INSTEX solely focuses on humanitarian trade, in other words, goods that are not subject to American sanctions. Why is there even a need for an instrument facilitating this legal and legitimate trade? Since the US withdrawal from the JCPOA, European banks have proven extremely reluctant to process these transactions, fearing American sanctions “irrationally and without reason”.³ This overcompliance phenomenon is a consequence of years of sanctions having been placed on banks, leading many to avoid taking any more risks.

In this regard, Iranians decried a lack of European efforts to convince banks that humanitarian trade is legal.⁴ The German interviewee assured that the E3 had carried out great outreach efforts to convince the banks that trade was safe and to offer advice on how to conduct it. However, he explained that they were unable to provide banks with the necessary assurances that they would be protected from possible US retaliation.⁵ The failure of European states to convince banks to trade unsanctioned items with Iran underpins the establishment of INSTEX.

Explaining the functioning of this instrument can only be theoretical given that it is still under development and does not fully function yet. Since banks are the gatekeepers to trading unsanctioned goods with Iran, INSTEX aims to avoid direct transactions between Europe and Iran. It acts as a third party holding the payments and redistributing them.

European companies importing Iranian goods will make payments to INSTEX and Iranian companies importing European goods will pay the money to the Special Trade and Finance Instrument (STFI), the mirror entity based in Iran, serving the same function as INSTEX. INSTEX and STFI then net the transactions, transferring European importers’ money to European exporters and same on the Iranian side. In the example of a European company A exporting medical goods to an Iranian company B, company B will make the payment owed to company A to STFI. Similarly, in case of an Iranian company C exporting food to a European company D, company D will make the payment owed to company C to INSTEX. When these payments have been made, STFI transfers company B’s money to company C and INSTEX transfers company D’s money to company A. Payments are exchanged between European companies through INSTEX and between Iranian companies through STFI.

This model, often dubbed an E3 initiative, was actually a joint endeavour with Iran.⁶ Once the model was agreed on, INSTEX – based in Paris – was set up by the E3 and STFI – based in Tehran – was set up by Iran.

There can be no objective scale measuring the effectiveness of INSTEX given that the instrument has yet to begin operation. Instead, an assessment of INSTEX at this juncture can only be made vis-à-vis the expectations of both parties – Europe and Iran – and what has been achieved to date.

Officially, when designing INSTEX, the E3 meant it as a solution for Europe to fulfil their commitments under the JCPOA and “try to mitigate the impact of the United States’ decision to reimpose sanctions”, while remaining aware that these efforts could not fully compensate

³ Nephew, R., interviewed by author, 22 November 2019

⁴ Iranian official, interviewed by author, 03 December 2019

⁵ German official, interviewed by author, 09 December 2019

⁶ Nephew, Iranian and German officials, 2019

the impact of American sanctions on Iran.⁷ The stance of Europe was to continue engagement with Iran rather than confrontation.

However, the EU official admitted that, although not being the official reason, INSTEX was primarily intended as a political gesture. Setting it up and getting it to function gave Europe a narrative of how they are trying to keep the JCPOA alive.⁸ As one European diplomat told Reuters, “it will not change things dramatically but it is an important message to Iran to show that we are determined to save the JCPOA”.⁹

Iranian expectations were contained in the Statement of the Joint Commission on the JCPOA of 6 July 2019.¹⁰ The 11 commitments listed in the text – such as the maintenance and promotion of extended economic relations with Iran, the continuation of the trade of oil and gas, as well as the protection of companies from the effects of extraterritorial US sanctions– constituted the hopes of Iran for European action following the American decision to withdraw from the agreement.¹¹

The stated aim of Europe gave Iran the impression that INSTEX was significantly going to support the resolution of the economic problems resulting from the sanctions. However, regarding the financial benefits, INSTEX has fallen well short of the expectations on both sides. Measured in trade, the achievements of INSTEX to date are zero. Despite Federica Mogherini’s – the High Representative for the Union for Foreign Affairs and Security Policy at the time – announcement late June 2019 that INSTEX had “become operational and [was] processing the first transactions”,¹² none of these transactions have been completed. This statement simply meant that buyers and sellers on both sides had been contacted and expressed interest in trading through the mechanism. During an interview, the EU representative admitted that the Union still did not know when the first transactions would be completed.¹³ However, the German official assured that it would be “very soon” without giving or knowing any more details. He added that INSTEX and STFI were in close contact and met regularly to discuss the pending issues.¹⁴ Even so, the pending transactions only amount to several million dollars, which according to Sergey Lavrov, Russian Foreign Minister is “nothing”.¹⁵

⁷ Mogherini, F. (2019) ‘Remarks by High Representative/Vice-President Federica Mogherini Following the Foreign Affairs Council’, European External Action Service, https://eeas.europa.eu/headquarters/headquarters-homepage/65472/remarks-high-representativevice-president-federica-mogherini-following-foreign-affairs-council_en

⁸ EU official, 2019

⁹ Irish, J. and Alkousaa, R. (2019) ‘Skirting U.S. sanctions, Europeans open new trade channel to Iran’, Reuters, <https://de.reuters.com/article/us-iran-usa-sanctions-eu/skirting-u-s-sanctions-europeans-open-new-trade-channel-to-iran-idUSKCN1PPOK3>

¹⁰ Joint Commission of the Joint Comprehensive Plan of Action (2019) ‘Statement of 6 July’, https://eeas.europa.eu/headquarters/headquarters-homepage/48076/statement-joint-commission-joint-comprehensive-plan-action_en

¹¹ Iranian official, 2019

¹² Tehran Times (2019) ‘Mogherini Says INSTEX Is Processing First Transactions’, Tehran Times, <https://www.tehrantimes.com/news/437594/Mogherini-says-INSTEX-is-processing-first-transactions>

¹³ EU official, 2019

¹⁴ German official, 2019

¹⁵ Luhn, A. (2019) ‘Russia Considers Joining EU Payment System Meant to Save Iran Nuclear Deal’, The Telegraph, <https://www.telegraph.co.uk/news/2019/07/18/russia-considers-joining-eu-payment-system-meant-save-iran-nuclear/>

Regarding the political expectations, INSTEX could be said to have successfully contributed to extending the life expectancy of the JCPOA. The Iranian increase in nuclear activity above JCPOA limits occurred a whole year after American withdrawal and this could be explained by the political efforts done by the EU through INSTEX. In that sense, INSTEX can be perceived as a moderately successful delaying tactic.¹⁶ However, the Iranian official explained that the Iranian government saw little value in INSTEX from the beginning. He claimed that, “we appreciate the political support, but it is not what we need”. He drew a parallel with the Model Additional Protocol of the IAEA saying that if Iran only orally supported the Additional Protocol rather than signed it, then the international community would not be satisfied. In that case, the political support INSTEX provides is not satisfactory if it does not come with financial results.¹⁷ This was confirmed on 5 January 2020 when Iran announced that it discarded “the last key components of its operational limitations in the JCPOA, which is the limit in the number of centrifuges”.¹⁸

Thus, comparing the results of INSTEX with what was promised by Europe and expected by Iran, it is clear that the mechanism has fallen short of what it aimed to achieve. No trade has been facilitated between the two yet and the Iranians claim that INSTEX had nothing to do with the delaying of the restarting of their nuclear activities.

What explains this apparent failure? One major shortcoming of INSTEX is that it only works in theory. If there is a general balance of trade, INSTEX and STFI can both net the amounts they receive and the exporters on both sides get paid. However, regarding humanitarian goods, there is a large trade imbalance. Although the food trade between Europe and Iran is essentially proportional, this is not the case regarding medical goods. In the first 11 months of 2017 European exports in medicine totalled €851 million and imports only €27 million.¹⁹ There should be a greater demand for humanitarian goods going through the mechanism from Iran than Europe and more money should be paid into STFI than INSTEX. As a result, this means that not enough money will be paid into INSTEX to give what is owed to all European exporters.

A second deficiency of INSTEX is its inherent inefficiency. INSTEX is little more than a recreation of an outdated pattern of trade facilitation: barter. This trading method was abandoned to move toward more rapid and efficient ways of doing business through the banks.²⁰ They were created to move money back and forth and provide confidence that goods are moved. They facilitate capital reallocation and provide guarantees. INSTEX is a crucial loss of that efficiency.

Third, the multinational character of the instrument hampers its functioning.²¹ INSTEX was created by four governments and has already expanded to include six additional European countries. In addition, many European companies have offices in the US and trade significantly

¹⁶ Nephew, 2019

¹⁷ Iranian official, 2019

¹⁸ Mehr News Agency (2020) ‘Iran Takes Final JCPOA Step, Removing Last Limit on Nuclear Program’, <https://en.mehrnews.com/news/154191/iran-takes-final-jcpoa-step-removing-last-limit-on-nuclear-program>

¹⁹ Geranmayeh, E. and Batmanghelidj, E. (2019) ‘Trading with Iran via the Special Purpose Vehicle: How it Can Work’, European Council on Foreign Relations, https://www.ecfr.eu/article/commentary_trading_with_iran_special_purpose_vehicle_how_it_can_work

²⁰ Nephew, 2019

²¹ Nephew, 2019

with the Americans, making US sanctions harder to escape and INSTEX participation more difficult. It is challenging to create consensus on such an endeavour. For a while, it was suggested that INSTEX be integrated in the EU. This idea was quickly abandoned when it became apparent that having 28 Member States agree to the mechanism in a timely fashion would prove impossible.²² INSTEX cannot escape the multilateralism deficiency given how built into the system it is.

INSTEX does not function today, but there are initiatives and discussions attempting to solve deficiencies and broaden the scope of the instrument. One of these solutions is to find options to fund the mechanism, in order to solve the problem of the balance of trade. If guarantees of payment are provided to European exporters, or if money is injected into the system, European companies would be more likely to trade through the instrument.

The first of these initiatives is dubbed the Macron Initiative. The French President Emmanuel Macron proposed to extend a \$15 billion line of credit to Iran on their future oil exports. The money would be injected into INSTEX as an advance on future Iranian oil export revenues. The certainty that Iran has oil reserves and will export them some time in the future constitutes a strong guarantee.

Unfortunately, the series of interviews conducted in preparation for this paper demonstrated that the initiative is extremely unlikely to succeed. The Iranian interviewee welcomed the proposal arguing that it provided a guarantee to European companies and obviously escapes sanctions because a credit cannot be sanctioned. However, granting the credit line was made dependent on US approval, which the Europeans currently do not have.²³ Javad Zarif, Foreign Minister of the Islamic Republic of Iran, deplored that “for the past five months, Europe has been trying to give us credit in return for the sale of the Iranian crude oil to make the country stay in the JCPOA, but it has not been able to do even this little job because it is not allowed by its master to spend its own money for its own security”.²⁴ Both the German and EU officials said they had no information on how much the initiative was progressing. The EU official said the initiative was “overblown” and interpreted the silence around it as a sign that “it is never going to happen”.²⁵ Mr. Nephew said, “in terms of practical implications, we should expect that this initiative will do almost nothing” because other European governments are reluctant to commit this amount of money.²⁶ Therefore, in absence of American approval, the initiative is highly unlikely to succeed.

There are other sources of funding that could help INSTEX start business, other than the Macron Initiative. The German official revealed that the E3 was considering other proposals to fund INSTEX such as injecting into the instrument the substantial overflight rights that are owed to Iran. When airlines fly above the territory of a State, they owe money to that State. However, since the reinstating of sanctions, these sums have not been paid to Iran. The idea would be to put this money directly into INSTEX as a direct contribution from Iran to pay

²² Nephew, 2019

²³ Iranian official, 2019

²⁴ Tasnim News Agency (2019) ‘Zarif Decries Europe for Following US Orders’, <https://www.tasnimnews.com/en/news/2019/09/30/2107857/zarif-decries-europe-for-following-us-orders>

²⁵ EU official, 2019

²⁶ Nephew, 2019

European exporters.²⁷ The project is only being discussed, however, and there are no concrete and agreed proposals to fund the instrument yet.

Besides solving the problem of the balance of trade, another proposal to modify INSTEX is to increase the number of shareholding countries. According to Federica Mogherini, INSTEX was always designed to be expanded. In a statement, she claimed that “a number of Member States have shown their willingness to become shareholders of this instrument and there is also the possibility for non-Member States to join”.²⁸ It remains to be seen whether third countries would be interested and willing to use the instrument.

It is admitted that other European governments are almost certain to join. The integration of new European States proves an important step that Europe claims to have always encouraged, in order to increase the ability of INSTEX to facilitate business. This is shown by the 29 November 2019 joint statement in which Belgium, Denmark, Finland, the Netherlands, Norway and Sweden declared they were in the process of becoming shareholders of INSTEX.²⁹

There is greater debate regarding non-European governments. China, India, Russia and Turkey are said to have expressed interest in joining the mechanism.³⁰ But there are no plans for these countries to join the mechanism soon. Even if interested, these governments are adopting a wait and see approach, gauging American response to the first transactions before committing to joining the instrument.³¹ The German official confirmed that there were no concrete discussions among the E3 about expanding INSTEX beyond Europe as their priority was facilitating the first transactions.³²

Expanding the geographical scope of INSTEX can be beneficial. Despite low expectations the interviewees had of the functionality of the instrument, having other countries join INSTEX could increase its value to Iran. At least, it would not have a negative impact on the already bleak perceptions the Iranians have of INSTEX. However, the recent announcement by six European countries to join INSTEX has received only lukewarm response from Iran. The statement closes on “In this context, it is crucial for the Islamic Republic of Iran to return without delay to full and verifiable compliance with the terms and provisions of the nuclear agreement”.³³ The Iranian interviewee understood that these six countries implied that their participation was contingent on Iranian compliance with the JCPOA. He argued that this was an unfair and unbalanced trade as the joining of these six countries did not have the potential to mitigate the American sanctions as expected by Iran.³⁴

²⁷ German official, 2019

²⁸ Mogherini, 2019

²⁹ Belgium, Denmark, Finland, the Netherlands, Norway and Sweden (2019) ‘Joint Statement on Joining INSTEX’, <https://www.government.nl/documents/diplomatic-statements/2019/11/29/joint-statement-on-joining-instex-by-belgium-denmark-finland-the-netherlands-norway-and-sweden>

³⁰ Batmanghelidj, E. and Shah, S. (2019) ‘Protecting Europe-Iran Trade to Prevent War: A Provisional Assessment of INSTEX’, European Leadership Network, https://static1.squarespace.com/static/54db7b69e4b00a5e4b11038c/t/5d154874a9e4b00001746352/1561675905136/ELN_B%26B+INSTEX+June+27+2019+ADVANCE+COPY.pdf

³¹ Nephew, 2019

³² German official, 2019

³³ Belgium, Denmark, Finland, the Netherlands, Norway and Sweden, 2019

³⁴ Iranian official, 2019

Another often discussed option is that INSTEX might include sanctioned items in the future, particularly oil, which is Iran's largest source of revenues and thus truly make a difference. It was Mogherini's ambition when designing INSTEX and on 15 July 2019, she stated that "the issue of whether or not INSTEX will deal with oil is a discussion that is ongoing among the shareholders".³⁵ However, none of the interviewees were optimistic about this prospect.

It was argued that the priority was to activate INSTEX, even within its limited scope. The current inability of INSTEX to complete a transaction on unsanctioned goods and the constant delays did not bode well for trade on sanctioned trade. "Europeans are not ready to enlarge the scope of INSTEX yet".³⁶ This assertion is supported by Mr. Zarif's claim that the priority for the E3/EU should be to sell products such as protective bandages for victims of epidermolysis bullosa.³⁷

Mr. Nephew said that to enlarge the scope of INSTEX to goods under American sanctions, European governments would have to agree to have a sanction fight with the US, something the E3 has completely set aside. Moreover, big European oil companies would not be willing to trade oil with Iran and risk US sanctions cutting them from the American market. The reason the proposal is still publicly discussed is to tell the Iranians what they want to hear and keep them on board.³⁸

The German interviewee confirmed that expanding the scope of INSTEX was not seriously on the table, repeating that the absolute focus of INSTEX at this stage was ensuring the completion of the first transactions. He added nevertheless that the focus of INSTEX on humanitarian goods was a necessity and that multiple companies had expressed interest to trade such goods through INSTEX. "It will be a challenge to process all [these demands] for the time being so it is not the moment to be expanding to other sectors".³⁹

The expansion of scope seems undesirable at this stage. It is accurate to state that INSTEX cannot currently function within its existing mandate to facilitate the trade of unsanctioned goods with Iran, so expanding to areas that are sanctioned seems unrealistic at present and is firmly opposed by the European petroleum companies and their governments. Expansion could also deter new possible shareholders for fear of US sanctions. In conclusion, Mr. Nephew said, "it is completely not going to happen, there is no intention to ever include oil".⁴⁰

At this stage, these are the only proposals on the table. There seems to be a shortage of creative ideas to enable INSTEX to function. The German representative stated that "improving" the mechanism was not a priority of the E3 "because it would imply that we have a mechanism that is fully established".⁴¹ Once INSTEX is able to complete transactions, then it can be improved. Less optimistic, Mr. Nephew thinks that there was "nothing more they could do to make INSTEX work" and added that "they were given an impossible mandate and they are doing the best they can do with it".⁴²

³⁵ Mogherini, 2019

³⁶ Iranian official, 2019

³⁷ Zarif, J. (2019a) Tweet 2 December, 2019, <https://twitter.com/JZarif/status/1201478075420233728>

³⁸ Nephew, 2019

³⁹ German official, 2019

⁴⁰ Nephew, 2019

⁴¹ German official, 2019

⁴² Nephew, 2019

INSTEX was announced as a solution to mitigate the impact of American sanctions on Iran – the only proposal by Europe to do so. Given the stated objective, it has clearly failed to achieve its goal. No transactions have been completed since the creation of INSTEX in January 2019, and Iran has lost all faith in the instrument. Politically, at best, INSTEX may have delayed the restarting of Iranian nuclear activities. However, this assertion is denied by Iran, especially that Iran announced it no longer abided to the limitations set out in the JCPOA. It is however to be noted that Iran continues to abide by and implement the International Atomic Energy Agency (IAEA) safeguards.

The failure of INSTEX to date can be explained by numerous factors, first of which is that it only works in theory. Europe exports significantly more humanitarian goods to Iran than the other way around. The netting mechanism cannot succeed if there is more money on one side of the equation than the other. The solutions proposed to fund the mechanism on the European side are either talk with little substance, like the Macron Initiative, or only at the development stage where members of the E3 have yet to come to an agreement, such as the overflight rights.

Other alternatives such as expanding beyond Europe and expanding the scope of the instrument to sanctioned goods like oil are not even seriously considered at this stage, as was demonstrated in the series of interviews conducted with both European and Iranian officials.

There certainly has been too much pressure put on an instrument that all the interviewees agreed was never considered to be a game changer. INSTEX might have suffered from a capability expectations gap despite this perception. Being the only proposal to mitigate the impact of American sanctions, there were naturally huge expectations, especially on the Iranian side, but the means invested into INSTEX and capabilities of the instrument did not allow it to deliver.

For now, INSTEX has been unable to fulfil its mandate and its options for the future look bleak. INSTEX's success might not have the potential of saving the JCPOA according to the interviews, but unless Europe manages to finally get INSTEX up and running, Iran will likely continue to attack the E3 on their lack of political credibility, accusing them of “bowing to US bullying”, instead of “exerting sovereignty”.⁴³

⁴³ Zarif, J. (2019b) Tweet 5 December, 2019, <https://twitter.com/JZarif/status/1202554296463740933>

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