



# EUROPEAN NON-PROLIFERATION DIPLOMACY IN THE SHADOW OF SECONDARY SANCTIONS

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After withdrawing from the Iran nuclear agreement, or the Joint Comprehensive Plan of Action (JCPOA), in May 2018, the United States imposed unprecedentedly harsh sanctions on Iran. Iran responded to this ‘maximum pressure’ campaign by reducing its JCPOA commitments. While the USA assumes that more pressure can lead to a ‘better deal’ with Iran, European non-proliferation policy is based on preserving the JCPOA.

The impact of US sanctions mainly derives from penalizing third parties for engaging with Iran. Such secondary sanctions make foreign banks reluctant to process Iran-related transactions—even when they fall outside the scope of US sanctions. Such sanction overcompliance makes it difficult for those European companies that still want to trade with Iran to do so. This has also meant that the European Union (EU) and the E3—France, Germany and the United Kingdom—have been unable to meet previous expectations regarding lifting of sanctions under the JCPOA. In addition to contributing to a deep socio-economic crisis within Iran, the sanctions have

undermined Iranian people’s access to basic humanitarian goods.

This policy brief describes European responses to US President Donald J. Trump’s administration’s secondary sanctions on Iran. In particular, it looks at the Instrument in Support of Trade Exchanges (INSTEX), which was developed by the E3 in 2019 to facilitate European–Iranian trade. It is argued that while falling short of the kind of economic normalization that was expected under the JCPOA, INSTEX has the potential to alleviate human suffering and free some European–Iranian trade from secondary sanctions. The instrument can also be seen as an experimental step towards a more independent European policy that could better withstand future disagreements with major powers.

## BACKGROUND

In the mid-1990s when the USA first imposed extraterritorial sanctions on Iran as part of the Iran and Libya Sanctions Act (ILSA), the European Council pushed back with the so-called ‘Blocking Regulation’.<sup>1</sup>

<sup>1</sup> US Congress, Iran and Libya Sanctions Act of 1996, Public Law 104–172, 5 Aug. 1996.

## SUMMARY

● This policy brief describes European responses to secondary sanctions that the United States imposed on Iran after withdrawing from the 2015 nuclear agreement, or the Joint Comprehensive Plan of Action (JCPOA). In particular, it looks at the Instrument in Support of Trade Exchanges (INSTEX), which was established by France, Germany and the United Kingdom in 2019 to facilitate European–Iranian trade, initially focusing on the humanitarian sector. While falling short of the kind of comprehensive economic normalization that was expected under the JCPOA, INSTEX could help maintain the ailing nuclear agreement in addition to addressing some of the negative humanitarian consequences of sanctions in Iran. INSTEX can also be seen as a test case for a more independent European foreign policy that could better withstand future disagreements with major powers.



In addition to prohibiting EU companies from complying with secondary sanctions, the 1996 regulation gave them the right to recover related damages.<sup>2</sup> The EU also threatened to take the dispute to the World Trade Organization (WTO). These measures contributed to the 1997 decision by President Bill Clinton's administration not to enforce the ILSA.<sup>3</sup>

However, the crisis over Iran's nuclear programme in the following decade created transatlantic solidarity on the need for non-proliferation sanctions, in which context the EU also accepted US secondary sanctions on Iran. In addition to United Nations Security Council sanctions in 2006–10, in 2012 the EU and the USA jointly imposed an oil embargo on Iran in an effort to end its uranium enrichment activities. They also targeted Iran's central bank and took measures leading to the exclusion of several Iranian banks from the Belgian-based Society for Worldwide Interbank Financial Telecommunication (SWIFT) system.<sup>4</sup>

After conclusion of the JCPOA in 2015, previous UN Security Council sanctions on Iran were terminated with Resolution 2231, and the transatlantic financial and banking sanctions were waived

or lifted.<sup>5</sup> Under the compromise agreement Iran could continue uranium enrichment under strict limits and intrusive International Atomic Energy Agency (IAEA) inspections.<sup>6</sup> For Iran the most significant benefit of the JCPOA was economic normalization from the lifting of sanctions. However, the most important factor enabling the agreement had arguably been new US flexibility on uranium enrichment in Iran, based on secret bilateral negotiations in 2012–13.<sup>7</sup> Yet, the diplomatic success was commonly explained as a result of sanctions.<sup>8</sup>

By withdrawing from the JCPOA the Trump administration rejected the underlying compromise, assuming that more coercive pressure could lead to more Iranian concessions on the nuclear issue as well as regional and missile policies. While the resulting maximum pressure strategy—by which the USA unilaterally imposed a near-total oil embargo on Iran—has demonstrated unparalleled US power over the global financial system, it has failed to reach its policy objectives. Instead, Iran responded by ceasing the implementation of key JCPOA commitments between May 2019 and January 2020, and Iranian hardliners opposing engagement with the West have

<sup>2</sup> European Council, Regulation No 2271/96 of 22 November 1996 protecting against the effects of the extra-territorial application of legislation adopted by a third country, and actions based thereon or resulting therefrom, 22 Nov. 1996.

<sup>3</sup> Katzman, K., 'The Iran Sanctions Act (ISA)', Congressional Research Service Report for Congress, updated 12 Oct. 2007.

<sup>4</sup> Gladstone, R. and Castle, S., 'Global network expels as many as 30 of Iran's banks in move to isolate its economy', *New York Times*, 15 Mar. 2012.

<sup>5</sup> UN Security Council Resolution 2231 (2015), 20 July 2015.

<sup>6</sup> Joint Comprehensive Plan of Action (JCPOA), Vienna, 14 July 2015, reproduced as Annex A of UN Security Council Resolution 2231, 20 July 2015.

<sup>7</sup> Rozen, L., 'Inside the secret US–Iran diplomacy that sealed nuke deal', *Al-Monitor*, 11 Aug. 2015.

<sup>8</sup> See e.g. The White House, 'The Iran nuclear deal: What you need to know about the JCPOA', 14 July 2015.



been empowered.<sup>9</sup> While distancing themselves from US policy, the E3/EU have condemned Iranian actions, calling for full compliance with the JCPOA.<sup>10</sup>

### INITIAL EFFORTS TO COUNTER SECONDARY SANCTIONS

To defend the JCPOA, in June 2018 the EU included the upcoming US secondary sanctions on Iran within the 1996 Blocking Regulation.<sup>11</sup> However, the Trump administration's obliviousness to the measure exposed the lack of an effective mechanism to enforce the legislation.<sup>12</sup> In contrast the US Treasury Department's Office for Foreign Asset Control (OFAC)—whose powers to enforce secondary sanctions were significantly broadened in the 2000s—has effectively deterred the private sector from Iran-related activities.<sup>13</sup>

<sup>9</sup> Press TV, 'Iran announces decision to take fifth step to scale back JCPOA commitments', 5 Jan. 2020; and Geranmayeh, E., 'Reviving the revolutionaries: How Trump's maximum pressure is shifting Iran's domestic politics', European Council on Foreign Relations Policy Brief, 23 June 2020.

<sup>10</sup> Erästö, T. and Cronberg, C., 'Will Europe's latest move lead to the demise of the Iran nuclear deal?', SIPRI Commentary, 21 Jan. 2020; and IAEA, 'NPT safeguards agreement with the Islamic Republic of Iran', Resolution adopted by the Board of Governors, GOV/2020/34, 19 June 2020.

<sup>11</sup> European Commission, Commission Delegated Regulation (EU) 2018/1100 of 6 June 2018 amending the Annex to Council Regulation (EC) No 2271/96 protecting against the effects of extra-territorial application of legislation adopted by a third country, and actions based thereon or resulting therefrom, 6 June 2018.

<sup>12</sup> Batmanghelidj, E. and Hellman, A., 'Europe, Iran and economic sovereignty: A new banking architecture in response to US sanctions', European Leadership Network, June 2018.

<sup>13</sup> See e.g. Sandberg-Zakian, E., 'Insight: OFAC \$7.8M settlement with Swiss company expands tech enforcement', Bloomberg Law, 16 Apr. 2020; and Arnold, A., 'A financial

The EU also failed to prevent the decision—taken by SWIFT under US pressure—to exclude Iranian banks from its payment system.<sup>14</sup> Even the European Investment Bank—whose mandate was extended to Iran as an additional response to US measures—considered investing in Iran too risky.<sup>15</sup>

### SHIFTING FOCUS TO SANCTION OVERCOMPLIANCE

In September 2018 the E3/EU announced a plan to develop a special trade instrument to 'facilitate payments related to Iran's exports (including oil) and imports' to 'assist and reassure economic operators pursuing legitimate business with Iran'.<sup>16</sup> However, by the time of its establishment in January 2019, the mission of the instrument—which was then named INSTEX—had been reduced, at least initially, to trade in humanitarian goods.<sup>17</sup>

Although it fell short of Iranian expectations, the limited mission of

*Although it fell short of Iranian expectations, the mission of INSTEX addresses a critical area of sanction overcompliance*

sanctions dilemma', *Washington Quarterly*, vol. 42, no. 3 (2019), pp. 57–71.

<sup>14</sup> Reuters, 'SWIFT says suspending some Iranian banks' access to messaging system', 5 Nov. 2018.

<sup>15</sup> Emmott, R. and de Carbonnel, A., 'European Investment Bank casts doubt on EU plan to salvage nuclear deal', Reuters, 18 July 2018.

<sup>16</sup> European Union External Action Service, 'Implementation of the Joint Comprehensive Plan of Action: Joint ministerial statement', Joint statements, 24 Sep. 2018.

<sup>17</sup> French Ministry for Europe and Foreign Affairs, '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 (JCPOA)', Joint statement by the E3 foreign ministers, 31 Jan. 2019.



### *Governmental ownership raises the threshold for the USA to impose sanctions on INSTEX*

INSTEX addresses a critical area of sanction overcompliance. In principle, humanitarian trade is exempt from sanctions, but the lack of specific reassurances from the USA has meant a failure to apply this exemption in practice.<sup>18</sup> As

noted in a 2019 UN report, the sanctions on Iran ‘unduly affect food security and the availability and distribution of medicines, pharmaceutical equipment and supplies’.<sup>19</sup> Iran produces most of its pharmaceutical products domestically, but international banking restrictions have hampered domestic production by limiting imports of raw materials and undermined Iran’s access to specialized medicines needed to treat cancer and other chronic or rare diseases.<sup>20</sup>

While the pre-2015 comprehensive sanctions regime on Iran also had negative humanitarian consequences, the severity of current US sanctions, alongside their counterproductive non-proliferation impact, has drawn renewed attention to the problem.<sup>21</sup> Criticism towards sanctions has increased with the coronavirus disease 2019 (COVID-19) crisis, as

<sup>18</sup> Borger, J. and Kamali Dehghan, S., ‘US rebuffs Europeans over ensuring Iran sanctions exempt food and medicine’, *The Guardian*, 2 Nov. 2018.

<sup>19</sup> UN General Assembly, ‘Situation of human rights in the Islamic Republic of Iran’, Report of the Special Rapporteur on the situation of human rights in the Islamic Republic of Iran, A/74/188, 18 July 2019.

<sup>20</sup> Kebriaeezadeh, A., ‘US sanctions are killing cancer patients in Iran’, *Foreign Policy*, 14 Aug. 2019.

<sup>21</sup> Erdbrink, T., ‘Iran sanctions take unexpected toll on medical imports’, *New York Times*, 2 Nov. 2012.

they have hindered timely delivery of international aid to Iran.<sup>22</sup>

### **HOW THE INSTRUMENT IN SUPPORT OF TRADE EXCHANGES SHOULD WORK**

INSTEX is a cross-border clearing mechanism based on exchange of goods or services that does not involve the transfer of currency between Europe and Iran. It plays the role of an intermediary between companies, together with its Iranian counterpart, the Special Trade and Finance Instrument (STFI). The goal is to compensate European exporters with funds located in Europe, based on the value commensurate with the value of imports from Iran. The STFI is similarly tasked to coordinate payments to Iranian exporters in accordance with the value of imports from Europe.<sup>23</sup>

INSTEX can reassure banks and companies through its joint ownership by three major European states (E3).<sup>24</sup> In addition to providing a high level of trust in the instrument’s due diligence procedures, governmental ownership raises the threshold for the USA to impose sanctions on INSTEX. In addition to the E3, four other European states—Belgium, Denmark, the Netherlands and Norway—have joined INSTEX as shareholders, and two more—

<sup>22</sup> Human Rights Watch, ‘US: Ease sanctions on Iran in COVID-19 crisis: Ensure access to essential resources’, 6 Apr. 2020; and Chadwick, V., ‘EU aid official slams banks’ overzealous sanctions strategy’, *Devex*, 18 June 2020.

<sup>23</sup> Batmanghelidj, E., ‘INSTEX develops new service in bid to fast-track Iran transactions’, *Bourse & Bazaar*, 30 July 2019.

<sup>24</sup> Geranmayeh, E. and Batmanghelidj, E., ‘Trading with Iran via the special purpose vehicle: How it can work’, *European Council on Foreign Relations*, 7 Feb. 2019.



Finland and Sweden—are expected to join soon.<sup>25</sup> Expanded ownership further contributes to risk and cost sharing and enforces the ‘sovereign shield’ around the instrument.<sup>26</sup>

After a delayed start the first INSTEX transaction took place on 31 March 2020, with a German company exporting blood treatment equipment to Iran.<sup>27</sup> Several European companies have indicated an interest in the mechanism, which they can use even if not domiciled in shareholder countries.<sup>28</sup> The E3 has said that INSTEX might later also be opened to non-European operators, and suggested that its scope could be extended beyond humanitarian trade.<sup>29</sup> However, INSTEX still needs to overcome major obstacles to function as intended.

## THE TRADE DEFICIT CHALLENGE

One key challenge facing INSTEX is that the value of European exports to Iran far exceeds the value of Iranian exports to Europe. This imbalance is largely due to the US sanctions on Iranian oil exports.<sup>30</sup> Without a balance, INSTEX is not sustainable, as European exporters cannot get due compensation based on European imports from Iran.

One potential solution being explored by INSTEX would be to

<sup>25</sup> Telephone interview with Michael Bock, 8 June 2020; and Batmanghelidh, E., ‘Europe still needs INSTEX to help solve the Iran crisis’, *Bourse & Bazaar*, 26 Feb. 2020.

<sup>26</sup> Geranmayeh and Batmanghelidj (note 24).

<sup>27</sup> Norman, L., ‘EU ramps up trade system with Iran despite US threats’, *Wall Street Journal*, 31 Mar. 2020.

<sup>28</sup> Batmanghelidh (note 25).

<sup>29</sup> French Ministry for Europe and Foreign Affairs (note 17).

<sup>30</sup> European Commission, ‘Countries and regions: Iran’, updated 23 Apr. 2020, accessed 1 June 2020.

pay European exporters using Iran’s revenues currently frozen in foreign banks.<sup>31</sup> While banks are reluctant to transfer Iranian funds due to fear of US sanctions, this option has already been applied by South Korea to allow a medicine delivery to Iran.<sup>32</sup> Switzerland has negotiated a similar arrangement with the USA as part of the Swiss Humanitarian Trade Agreement (SHTA).<sup>33</sup> However, these bilateral channels are dependent on OFAC permission, requiring lengthy negotiations and intrusive information sharing with the US Government.<sup>34</sup> A similar route would hardly be an option for INSTEX, which operates under EU law and data protection requirements.<sup>35</sup>

Alternatively, Iran could be offered a loan to buy humanitarian goods. The COVID-19 crisis prompted the country to apply for a \$5 billion loan from the International Monetary Fund (IMF). The head of Iran’s central bank suggested that the money could be channelled through INSTEX and SHTA.<sup>36</sup> Although the USA is seeking to block this option, the loan could be granted, depending on IMF support.<sup>37</sup>

Finally, the chances of striking a functioning trade balance could be

<sup>31</sup> Mallard, G. et al., ‘The humanitarian gap in the global sanctions regime: Assessing causes, effects, and solutions’, *Global Governance*, vol. 26 (2020), pp. 121–53.

<sup>32</sup> *Financial Tribune*, ‘S. Korea sending first humanitarian cargo’, 29 May 2020.

<sup>33</sup> Ackerman, S., ‘Iran has gotten nothing from US “humanitarian” channel’, *Daily Beast*, 8 May 2020.

<sup>34</sup> Mallard et al. (note 31).

<sup>35</sup> Telephone interview with Michael Bock (note 25).

<sup>36</sup> Motevalli, G., ‘Q&A: Iran’s Central Bank governor comments on IMF loan request’, *Bloomberg*, 19 Apr. 2020.

<sup>37</sup> Atwood, K., ‘US ready to block Iran’s requests for coronavirus aid from the IMF, officials say’, *CNN Politics*, 9 Apr. 2020.



increased through the expansion of INSTEX to non-European companies importing goods from Iran, and extension of the INSTEX mandate beyond humanitarian goods.

### LOOKING AHEAD

While Iranian–US relations and the fate of the JCPOA will affect INSTEX, its mission of countering the negative effects of secondary sanctions remains relevant irrespective of political developments. In addition to making INSTEX fully functional, European governments might also decide to take further steps to counter secondary sanctions.

### Impact of Iranian–United States relations

Democratic Party victory in the November 2020 US presidential elections could open the door to Iranian–US diplomacy—provided the political developments within Iran allow this.<sup>38</sup> However, diplomacy would depend on the lifting of sanctions, which would be particularly difficult given the private sector’s disillusionment with the Obama administration’s previous assurances about the safety of engaging with Iran.<sup>39</sup> INSTEX could help address this problem by providing additional reassurance to risk-averse banks and companies.<sup>40</sup>

A deal between Iran and the current US administration has

<sup>38</sup> Geranmayeh (note 9).

<sup>39</sup> Treanor, J., ‘HSBC criticises John Kerry over business with Iran request’, *The Guardian*, 13 May 2016.

<sup>40</sup> Online interview with Esfandiyar Batmanghelidj, 12 June 2020.

remained elusive. Hence, the re-election of Trump might mean continuation of the current situation—or it could be the breaking point. That point might be reached even earlier due to the recent US plan to either extend the arms embargo under Resolution 2231 or trigger a ‘snapback’ of previous UN Security Council sanctions on Iran.<sup>41</sup>

The collapse of the JCPOA would likely reduce European commitment to INSTEX. Yet, the instrument’s humanitarian mission should be viewed as a matter of ethical necessity, rather than a nuclear-related concession. Therefore, INSTEX would be important even without the JCPOA.<sup>42</sup>

### Beyond humanitarian trade?

As E3 foreign ministers said in January 2019, ‘INSTEX will support legitimate European trade with Iran, focusing initially on the [humanitarian] sectors most essential to the Iranian population’.<sup>43</sup> This seemed to suggest a potential future expansion beyond humanitarian trade.

The current INSTEX president, Michael Bock, confirmed that the instrument could cover other areas once humanitarian trade runs more smoothly. From a legal perspective the instrument could even include oil trade, but in practice it cannot be expected to go against US sanctions, as this would mean withdrawal of European bank cooperation.<sup>44</sup> While INSTEX cannot undo the

<sup>41</sup> Masterson, J., ‘US aims to extend Iran embargo’, Arms Control Association, June 2020.

<sup>42</sup> Batmanghelidj (note 25).

<sup>43</sup> French Ministry for Europe and Foreign Affairs (note 17).

<sup>44</sup> Telephone interview with Michael Bock (note 25).

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de facto primacy of US law, it could be extended to non-humanitarian trade that is not targeted by the USA but is impeded by fear of US secondary sanctions, including tourism and trade on various consumer goods.<sup>45</sup>

### **Potential further steps towards European economic sovereignty**

Since 2018 the EU approach has shifted from attempts at persuading the USA and seeking to counter secondary sanctions to addressing the problem of sanction overcompliance. This moderation of goals can be understood in light of the constraints that a dollar-dominated world economy imposes on European autonomy, as well as reluctance to engage in open confrontation with the USA. However, the prospect of INSTEX being targeted with US sanctions might still push the E3/EU to take further steps.

Based on previous proposals, one such step could be a coordinated approach to enforcing the Blocking Regulation through a new European enforcement authority.<sup>46</sup> Instead of penalizing companies for non-compliance with EU law, such an authority could provide them with advice on due diligence and on seeking reparation from damage caused by secondary sanctions.<sup>47</sup> The E3/EU could also establish a fund to compensate for such damage.<sup>48</sup>

<sup>45</sup> German–Iranian Chamber of Industry and Commerce, ‘Ich appelliere an alle Seiten, Vertrauen in uns zu setzen’, Interview with Michael Bock, 6 Feb. 2020.

<sup>46</sup> Geranmayeh, E. and Lafont Rapnouil, M., ‘Meeting the challenge of secondary sanctions’, European Council on Foreign Relations Policy Brief, 25 June 2019.

<sup>47</sup> Batmanghelidh and Hellman (note 12).

<sup>48</sup> Online interview with Jonathan Hackenbroich, 25 June 2020.

Other proposals include: taking sanctions disputes to the WTO; involving European central banks in Iran-related transactions; threatening retaliatory measures in response to arbitrary inclusion of European entities in OFAC’s Specially Designated Nationals list; and in the long term, strengthening the role of the euro as a global currency.<sup>49</sup> Other developments— notably the recent US sanctions on the Nord Stream 2 gas pipeline project—might be seen to warrant similar measures.<sup>50</sup> Indeed, from the Iranian perspective Europe’s assertive response to the pipeline sanctions contrasts with its position on Iran-related sanctions, suggesting that Europeans could have done more to safeguard the JCPOA.<sup>51</sup>

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### **Arms control as part of regional security arrangements**

The transatlantic approach to the Iran nuclear issue has relied heavily on sanctions, and survival of the JCPOA depends on the lifting of sanctions. Yet, it can hardly be concluded that sanctions are an effective non-proliferation tool. Academic literature suggests that sanctions rarely work, and the Iranian case is not necessarily an exception.<sup>52</sup> As noted above the JCPOA involved a major concession

<sup>49</sup> Geranmayeh and Lafont Rapnouil (note 46).

<sup>50</sup> RadioFreeEurope/RadioLiberty, ‘Germany says further US sanctions over Nord Stream 2 would interfere with EU energy security’, 14 June 2020.

<sup>51</sup> Online interview with Bijan Khajehpour, 5 June 2020.

<sup>52</sup> Morgan, T. C. and Schwebach, V. L., ‘Economic sanctions as an instrument of foreign policy: The role of domestic politics’,

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on uranium enrichment also on the US side, which, if tried earlier, might have allowed a diplomatic solution even without sanctions. From this perspective, the maximum pressure policy can be seen as reflecting the unlearned lessons about the importance of mutual compromise for the JCPOA. At the same time, the policy has undermined the credibility of promises of sanction lifting in future diplomatic negotiations.

The E3/EU would therefore do well to explore non-proliferation approaches that are less reliant on sanctions. One alternative could be a regional arms control strategy in the Middle East, as the need for nuclear confidence building also applies to Iran's neighbours. Europe could promote regional dialogue as part of this effort. In addition to helping to remove political obstacles to Iranian-US diplomacy, improved relations among Middle Eastern states could, in the long term, pave the way for cooperative security

International Interactions, vol. 21, no. 3 (1995), pp. 247–63.

arrangements, possibly including arms control.<sup>53</sup>

## CONCLUDING REMARKS

The current US strategy has undermined the perceived utility of non-proliferation sanctions, making them appear as a pitfall, rather than a tool, of non-proliferation in Iran. Reflective of this view, INSTEX seeks to alleviate the negative effects of secondary sanctions. While its impact on European-Iranian trade remains minimal, INSTEX demonstrates European solidarity on the JCPOA, and can help maintain the agreement until diplomatic solutions are found. INSTEX can also be seen as a test case of a more independent European foreign policy, which is needed to develop sustainable non-proliferation approaches and reduce the humanitarian harm caused by sanctions.

<sup>53</sup> Erästö, T., 'The arms control-regional security nexus in the Middle East', EU Non-proliferation and Disarmament Papers No. 68, Apr. 2020.

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