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SPECIAL BRIEFING

Economic Impact of the Iran Nuclear Deal: Part II

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OVERVIEW

After years of negotiations the international community finally lifted its sanctions on Iran in mid-January. This clears the way for a return to the global stage of the world's 28th largest economy: the single biggest diplomatically-driven economic game-changer since the fall of the Iron Curtain in 1989. Moreover, Iran currently holds 9.3% of the world's proven oil reserves and a massive 18.2% of the world's proven gas reserves, according to British Petroleum. Leaving aside the political and security implications of the deal, this briefing looks at what the outcome means over the next few years for Iran, the region and the world in terms of economic and commercial impacts.

A number of caveats should be noted in respect of the lifting of sanctions. First, the sanctions can be reapplied at any time if Iran is found to be in contravention of the agreement. Sanctions would then be reapplied for at least ten years, with a possible extension for a further five years. In addition, a number of sanctions remain in place, including a UN arms embargo for the next five years. More importantly, a number of US sanctions predate the nuclear dispute, stretching back as far as the Tehran embassy hostage crisis in 1979, while sanctions remain in place against persons and companies with links to the Revolutionary Guards. Both these sets of sanctions are unlikely to be lifted in the medium term. Indeed, we expect the Republican-dominated Congress to continue to try and impose further sanctions, although it is likely that any far-reaching measures would be overturned by President Obama. However, a Republican president would be likely to support further sanctions, ensuring that risks for US businesses dealing with Iran remain elevated.

Although the Iranian economy and businesses will undoubtedly benefit from the lifting of sanctions, we must caution that a number of factors will curtail potential business activity. First, in relation to the hydrocarbon sector, Tehran's latest contracts do not meet international norms, although they are better than previous versions and have met with approval from the international oil companies. Second, the business environment remains challenging: the World Bank's *2016 Doing Business Report* ranks Iran 118 out of 189 countries surveyed, and corruption is endemic (in Transparency International's *2015 Corruptions Perception Index*, Iran was ranked at 130 out of the 168 countries surveyed). Third, much business activity is dominated by quasi-state companies such as the *bonyads* (charitable foundations) controlled by the clergy and the business wing of the Revolutionary Guards. This creates an uneven playing field, not just for foreign companies but also for domestic companies without links to the political establishment.

Regionally the deal will have positive and negative impacts. Countries that act as an entrepôt hub for Iran, such as the UAE, will benefit from the increased trade opportunities and from the provision of business services. However, the weakening of oil prices will also curtail economic growth potential in these same countries. More broadly, we expect that companies from regional countries that have helped Iran by-pass or mitigate the sanctions regime, such as the Gulf states and Turkey, will be favoured in the post-sanctions environment, putting Western companies at a possible disadvantage.

At a global level the deal will boost trade and investment flows at a time when both flows are weak due to other headwinds in the global economy, such as lower Chinese growth. Furthermore, it will ensure that downward pressure remains on oil and gas prices into the medium term as access to the country's vast reserves is opened up fully, boosting profitability in global energy-intensive manufacturing and transportation sectors in the short term, but curtailing investment in the oil and gas sector. Importantly, the lack of investment will result in a sharp rebound in energy prices into the medium term as supply falls behind demand.

COMMERCIAL IMPLICATIONS

- The opening-up of the world's 28th largest economy after almost ten years of international sanctions will create significant opportunities throughout the economy. The first areas to benefit will be the upstream and downstream hydrocarbon sectors, as well as business services, infrastructure, car production, civil aviation and tourism.
- In the longer term, we expect all areas of the Iranian economy to open up, including the financial sector; however, expertise in Islamic finance will be needed to take advantage of any opportunities in that particular sector.
- Nevertheless, the improving situation could deteriorate quickly if the deal starts to unravel, which would threaten any assets held in the country.
- US companies might wait until after the US presidential elections in December 2016 before committing assets to Iran.
- In addition, European banks will be wary of becoming involved in cross-border operations for fear of fines being imposed by US regulators for breaking US sanctions. Many banks previously fined for breaching sanctions have committed to not dealing with Iranian passport holders or companies.

RECOMMENDATIONS

- Build relationships with the local business community with a long-term view, taking into account the importance of personal relationships.
- Identify areas within the hydrocarbon, business services, infrastructure, car production, civil aviation and tourism sectors in which opportunities will exist once sanctions are rescinded.
- Ensure that any Iranian companies you do business with are not linked to the Revolutionary guards, against which sanctions remain in place.
- Expect the business operating environment to remain challenging into the medium term.
- Expect FX and transfer risk to remain elevated despite the lifting of sanctions.
- Monitor the political situation: policy outcomes are the result of the complex interaction between unelected and elected groups, among which there is an ever-changing balance of power.
- In areas with high numbers of ethnic minorities, be prepared for sporadic outbreaks of violence.
- Take advantage of political risk insurance, where available.

OUTLINE SCENARIOS

SCENARIO A

All sides adhere to the deal and cross-border trade and investment becomes normalised.

WE ASSIGN A 70% PROBABILITY TO THIS SCENARIO.

SCENARIO B

A Republican candidate wins the US Presidential election and, backed by a Republican-dominated Congress, invokes stronger sanctions against Tehran as a sponsor of state terrorism and/or on human rights violations. The deal continues but US companies are put at a disadvantage in Iran, with slower growth in Iran being another consequence.

WE ASSIGN A 10% PROBABILITY TO THIS SCENARIO.

SCENARIO C

A Republican candidate wins the US Presidential election and, backed by a Republican-dominated Congress, invokes stronger sanctions against Tehran as a sponsor of state terrorism and/or on human rights violations. However, these sanctions include the possibility of halting access to the US market for companies from non-US countries dealing with Tehran. As a result, the nuclear deal breaks down.

WE ASSIGN A 5% PROBABILITY TO THIS SCENARIO.

SCENARIO D

A conservative candidate wins the 2017 Iranian presidential election and, backed by a conservative-dominated parliament, opts to restart the nuclear programme. As a result international sanctions are reapplied for a minimum of ten years.

WE ASSIGN A 15% PROBABILITY TO THIS SCENARIO.

BACKGROUND AND CONTEXT

The international community has built up a network of sanctions against Iran since the US first invoked sanctions in 1979 as a result of the American embassy hostage crisis in Tehran. US sanctions have been increased incrementally over the years in response to various political events, including Iran's support for groups designated as terrorists by the US government. As a result, by the mid-1990s the US banned virtually all trade and investment activities with Iran by US persons, wherever they were located. Furthermore, in 1996 it formalised its efforts to stop investment in Iran's hydrocarbon sector with the passing of the Iran and Libya Sanctions Act, which amongst other things threatened non-US oil companies with action if they invested more than USD40m in the hydrocarbon sector.

Furthermore, international pressure mounted from 2002, when it was first made public that Iran was secretly building two nuclear plants. However, it is suspected that the intelligence agencies were already aware of the plants. Indeed, Iran's nuclear industry dates back to the 1950s, when it had the full support of the US, although this support was withdrawn after the 1979 revolution. Shortly after the building of the new plants was made public, negotiations began with the international community, represented by the EU-3 (France, Germany and the UK). The collective aim was to gain Tehran's co-operation in monitoring the nuclear programme under the auspices of the IAEA.

The negotiations limped along until the 2005 election of President Mahmoud Ahmadinejad, who immediately raised the stakes by renewing enrichment activities. This provoked a series of sanctions by the international community with the aim of encouraging Tehran to suspend enrichment. US sanctions were ramped up from 2005, while UN sanctions began in December 2006, with EU sanctions following from 2007.

Unlike the case with Iraq, which saw the international community take control of Iraqi oil exports, international sanctions against Iran were weaker but still aimed to make it more difficult for its hydrocarbon sector to operate, develop and export. In combination with the country's own weak business environment and inappropriate economic policies (particularly under the Ahmadinejad presidency, 2005-13), sanctions have proven effective.

By 2012 the Iranian economy was in trouble: it contracted by 5.9% in 2012, followed by a further contraction of 1.7% in 2013. In addition, according to OPEC data, oil production fell from an average of 3.826m barrels per day (b/d) in 2011 to 2.673m b/d in 2013. Although the policies adopted by the new government of President Hassan Rouhani (2013-date) have helped turn the economy around, it is still underperforming. Furthermore, the new oil minister has been proactive in raising output, although it still remains weak by historical standards, at an average of 2.882m b/d in December.

The deal agreed on 16 January will see Iran continue its enrichment programme to a level suitable for civilian rather than military purposes (Tehran has always claimed the programme was peaceful), albeit under strict monitoring by the IAEA for the next 15 years. In return, sanctions applied in relation to the nuclear programme by the UN, US and EU have been lifted. However, the sanctions can be reintroduced 65 days thereafter for a period up to 15 years if Iran fails to comply with the agreement.

For more information on Dun & Bradstreet's country risk capabilities.
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