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Exuberance in Europe, Restraint in America: Iran Sanctions Realities

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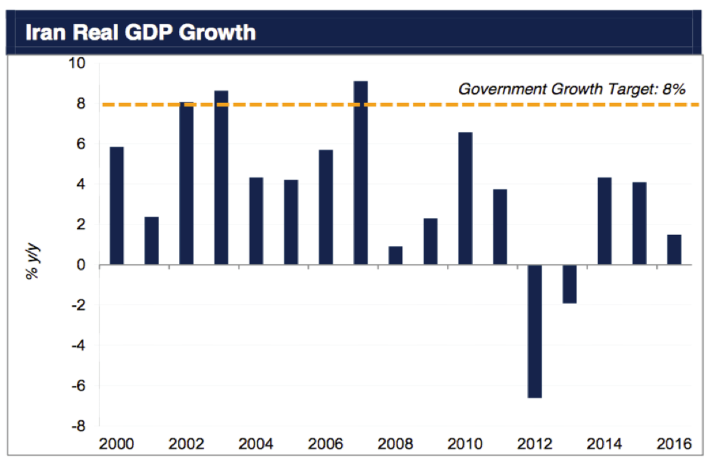
Exuberance in Europe, Restraint in America: Iran Sanctions Realities

By Karen E. Young

Iran has made its debut. Since the Joint Comprehensive Plan of Action, the U.S.-led nuclear deal with Iran, took effect on January 16, Iran has orchestrated a flurry of diplomatic activity between European trade ministers, while courting attention from Russia and China. Yet, the United States is the wallflower at the party. Iran now seeks as much as $50 billion in foreign direct investment per year after the lifting of U.N. and EU sanctions with the implementation of the JCPOA.[1] Iran's gross domestic product growth target of 8 percent per year would require about $90 billion in foreign investment and external financing, according to Moody's.[2] Iran's targets are ambitious, but not unprecedented in its recent history, as data from Emirates NBD and Bloomberg suggest. See Chart 1.

These are ambitious targets, and the Iranian government is both articulating these goals and speedily initiating conversations with potential investors. There are visits and trade delegations, promises, and expressions of mutual interest. Iran has created an emerging market euphoria not seen since the early 1990s when the former Socialist republics opened their doors to foreign direct investment and privatization schemes. Journalists have called Iranian President Hassan Rouhani's visit to Europe at the end of January a "shopping spree,"[3] while a cottage industry of "fixers"[4] have emerged to help open doors to foreign investors in Iran. On a state visit to Iran in early February, German Foreign Minister Frank-Walter Steinmeier asked Rouhani to "keep Germany in mind" on his next visit to Europe.[5]

Chart 1: Iran Real GDP Growth, as a Percent Year on Year



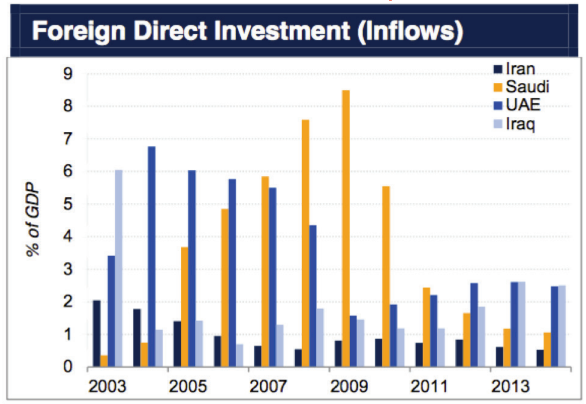
Bloomberg, Emirates NBD Research

1 Najmeh Bozorgmehr, "Iran hopes for $50 bn in investment as sanctions lifted," *Financial Times*, January 17, 2016.
2 Daniel J. Graeber, "Iran head of the game, Moody's finds," *UPI*, February 3, 2016.
3 Greg Myre, "With sanctions gone, Iran goes on a shopping spree in Europe," *NPR*, January 28, 2016.
4 Najmeh Bozorgmehr and Simeon Kerr, "Fixers line up to help foreign investors do business in Iran," *Financial Times*, January 29, 2016.
5 Paul Carrel, "Germany's Steinmeier tells Iran's Rouhani: please visit Germany," *Reuters*, February 3, 2016.

Rouhani's visit to Italy in January secured deals worth $22 billion in infrastructure and power development. Purchase orders for aircraft in France and manufacturing partnerships with automakers Peugeot Citroen and Renault SA will invigorate the transport sector and create much-needed jobs for Iran's well-trained workforce, as many as 700,000 strong, in the auto industry.[6] Iran's oil and gas industry will also be able to re-enter European markets with the easing of EU sanctions with the JCPOA. Since July 1, 2012, the European Union placed an embargo on Iranian oil, a loss of approximately 600,000 barrels per day at 2011 levels. Greece, Spain, and Italy were especially hard-hit at a time of economic recession when they had purchase agreements in place for as much as 10 percent of their oil imports from Iran. Natural gas imports from Iran will also restart, ending an embargo from the European Union since October 2012.[7]

Foreign direct investment inflows to Iran are well below regional rivals, which indicates the potential growth should some of existing foreign investment redirect toward Iran. Recent figures from Emirates NBD illustrate this trend. See Chart 2.

Chart 2: FDI as a Percent of GDP to Iran, Saudi Arabia, UAE, and Iraq



UNCTAD, Emirates NBD research

There remain a number of U.S. bilateral sanctions against Iran, blocking interaction between U.S. persons (defined as entities organized in the United States, U.S. citizens and permanent residents, and persons located or operating in the United States) and Iran.[8] Despite the growing rapport between U.S. Secretary of State John Kerry and Iranian Foreign Minister Mohammad Javad Zarif, official relations between the United States and Iran remain very limited. The U.S. foreign policy position toward Iran continues to be hawkish, at least in new and existing laws blocking commercial ties and discouraging U.S. citizen travel. Most importantly, the U.S. position on Iran as a state supporter of terrorism has not changed.[9] Not only do most U.S. sanctions remain in place, but new sanctions were implemented on January 17 in response to Iranian missile tests in the fall of 2015.[10]

While the United States stands to gain very little economically from the lifting of sanctions as a result of the JCPOA, the Obama administration has opted to gain a diplomatic victory and a bargain that the reward of partial liberalization and market access (as well as international legitimacy) can compel compliance in limiting nuclear militarization. By maintaining U.S. sanctions against Iran, the United States holds some leverage over key individuals close to the Iranian military apparatus. More importantly, the United States still holds some leverage over those international corporates and financial institutions seeking to do business in Iran while maintaining a presence in the United States. It is the power of the U.S. economy, and the

6 Jason Rezaian, "Iran's automakers stalled by sanctions," *The Washington Post*, October 14, 2013.
7 Kenneth Katzman, "Iran Sanctions," *Congressional Research Service*, 7-5700, RS20871, (January 16, 2016): 34.
8 "Iran sanctions relief implemented," *Freshfields Bruckhaus Deringer*, January 18, 2016.
9 "State Sponsors of Terrorism List," *U. S. Department of State*.
10 "Iran: U.S. imposes new sanctions after missile test," *BBC*, January 17, 2016.

enforcement capacity of the U.S. Treasury Department, that will temper the current euphoria.[11] The United States will be able to impact the risk premium of doing business in Iran, at least for the short term.[12] Arguably, many U.S. businesses will also forfeit opportunity, especially those in the retail, aircraft, automotive, financial services, software, and pharmaceuticals industries.

Remaining Sanctions After Implementation Day, January 16, 2016

The first challenge is to understand the current reality of U.S. economic and political relations with Iran. The changes in U.N., EU, and U.S. sanctions against Iran are extensive. For U.S. individuals and entities, it is *still* illegal to:

- Do business in Iran without a license from the U.S. government
- Use U.S. dollars in the context of Iranian business, or transfer funds through U.S. banks
- Export or re-export goods originating in the United States, technology, or software (restrictions on the export or re-export of these goods applies to non-U.S. individuals and entities as well)

However, for non-U.S. individuals and entities, the financial services sector in Iran is now open. Funds may be transferred to and from Iranian individuals and entities (with the exception that there remain U.S. penalties for non-U.S. citizens and entities that do business with Iranians designated as subject to U.S. secondary sanctions – meaning those still blacklisted). The sale and purchase of Iranian oil, gas, and petrochemicals is permitted. Automotive, shipping, and air cargo restrictions are lifted. The export of software and some metals is allowed.

Not only do most U.S. sanctions remain in place, but new sanctions were implemented on January 17 in response to Iranian missile tests in the fall of 2015.

There is some U.S. sanctions relief, which will benefit limited U.S. business interests.[13] The United States has also removed more than 400 names from the "special designated nationals" or SDN list, a list of Iranian citizens with whom the United States prohibited any U.S. entity (namely banks or commercial interests with operations in the United States) from engaging in transactions. There is a new list, the "E.O. 13599 List" of Iranian persons (including individuals as well as any other entities owned or controlled by the government of Iran and Iranian financial institutions) with whom U.S. persons are not permitted to engage commercially.[14]

However, the U.S. Treasury Department's Office of Financial Assets Control (OFAC) has issued General License H, which authorizes non-U.S. entities owned or controlled by a U.S. person to

11 See for example, new efforts at targeting financial networks linked to Iran and state-sponsored terrorism. "Treasury sanctions key Hizballah money laundering network," *U.S. Department of the Treasury*, January 28, 2016.

12 "Economic Implications of Agreement with the Islamic Republic of Iran," *International Monetary Fund*, *Regional Economic Outlook*, 2015.

13 "Frequently Asked Questions Relating to the Lifting of Certain U.S. Sanctions Under the JCPOA," *U.S. Department of the Treasury*, January 16, 2016.

14 "List of Persons Identified as Blocked Solely Pursuant to Executive Order 13599," *U.S. Department of the Treasury, Resource Center*, January 16, 2016.

engage in most business with Iran.[15] This becomes a very useful loophole for U.S. businesses and investors that own a stake in or control entities that are not based in the United States to do business in Iran. The only stipulation in this case is that the U.S. person cannot be involved in the day-to-day operations of business with his or her non-U.S. entities conducting business with Iran. Interestingly, in these cases, U.S. persons with an ownership stake or interest in a non-U.S. entity with business in Iran (after receipt of a new H license) can share globally integrated computer systems (email, servers, accounting systems, etc.). This will make the "Chinese wall" (the so-called wall dividing bank operations between proprietary trading and client interests) between ownership interest and day-to-day operations potentially hollow.

Further, for select industries there are possible trade openings between U.S. businesses and Iran. For example, U.S. and non-U.S. persons are eligible for a special license from OFAC to export, re-export, lease, sell, or transfer American commercial passenger aircraft (and their parts and services) as long as the equipment is used for civilian purposes. Therefore, a non-U.S. person or business might be able to buy used American aircrafts or parts and re-export them to Iran. Iran is in dire need of new commercial and military aircraft.[16] However, the French and Chinese may have offered a better opportunity already, for civilian and military aircraft.[17] The French commercial jet manufacturer Airbus will sell 114 civilian aircraft to Iran, though the commercial industry (state-owned) will need as many as 500 aircraft to replace its aging fleet.[18] U.S. concessions to allow imports of carpets, pistachios, and caviar – though important for many small scale women's weaving and knotting cooperatives and farmers – will be negligible compared to losses in U.S. export opportunity in other higher technology fields.

For select industries, there are possible trade openings between U.S. businesses and Iran.

Opportunity in Iran

With the easing of EU and U.N. sanctions, there will be an economic opportunity in Iran simply because of the attractive demographics of the country, the dated infrastructure and manufacturing sectors in need of investment, and the government's interest in privatization and foreign direct investment.[19] There remain important questions on the extent of the opportunity and the cost of doing business in a legal system that has been on the World Bank's lower tier of "Ease of Doing Business" survey for years, one in which corruption and close ties between elements of the state and/or military and business are difficult to navigate.[20] Iran ranked 118 out of 189 countries in 2016 on the World Bank survey, between Ecuador at 117 and Barbados at 119.[21] The financial services, telecommunications, and power sectors in Iran are in desperate need of investment and modernizing, but they are also those with close ties

15 "Office of Foreign Assets Control - Sanctions Programs and Information," *U.S. Department of the Treasury*.

16 "Air Force Modernization," *Global Security*.

17 On French aircraft, see Abbas Qaidaari, "Will Iran buy French warplanes?" *Al Monitor*, August 3, 2015. On Chinese aircraft, see: Christopher Harress, "China and Iran Weigh $1 billion deal to swap Chengdu J-10 fighter jets for major oil field," *International Business Times*, August 8, 2015.

18 Asa Fitch and Robert Wall, "Iran plans to buy 114 civilian aircraft from Airbus," *The Wall Street Journal*, January 16, 2016.

19 Karen E. Young, "Imagining Economic Opportunity in Iran," *Arab Gulf States Institute in Washington*, July 16, 2015.

20 "Ease of Doing Business in Iran, Islamic Republic," *World Bank Group*, *Doing Business 2016*.

21 "Doing Business: Measuring Business Regulations," *World Bank Group*, *Doing Business 2016*.

to military elements of the regime.[22]

For its part, the Rouhani administration is skillfully guiding economic policy to keep public spending low, limit drastic regulatory changes and disruptions of current patterns of ownership within the financial system, and rely on outside investment for big ticket expenditures in infrastructure. Iran will likely meet its foreign direct investment targets and, even more importantly, continue to diversify its economy from oil revenue. Iran has made it very clear that it intends to increase production up to one million barrels per day within a year, in addition to the 500,000 barrels per day it is currently able to export from stored supply.[23] The increase in production will re-establish Iran's presence in international crude markets, a priority more important than calls for an OPEC production reduction to drive up prices.[24]

The financial services, telecommunications, and power sectors in Iran are in desperate need of investment and modernizing, but they are also those with close ties to military elements of the regime.

In some ways, the oil revenue Iran will create will be a bonus. Iran is cautiously projecting its fiscal budget with less than 25 percent of revenue next year from oil exports. As Bloomberg recently reported, Iran's projected budget for 2016 expects more revenue from taxes than from oil exports.[25] Taxes are going up in Iran, as much as 15 percent, and if the middle class population can share in some of the expected growth, the government will be rewarded. If the administration is able to expand the tax base to include currently exempt entities, including the numerous charity organizations and *bonyads* (charitable trusts) connected to the Revolutionary Guards, that will be a real coup.

How Does U.S. Strategy (or Reticence) Affect Gulf Allies?

For the Gulf states, there is a divergence of threat perception and potential benefit from a politically and economically ascendant Iran in the region. This is not necessarily new. Oman has had strong diplomatic and trade ties with Iran for decades. So has the United Arab Emirates, until somewhat recently. Saudi Arabia is most threatened by Iran, both ideologically in Iran's use of political Islam as a tool of revolution and by Iran's potential military and economic dominance in the region. Qatar stands to gain with an economically ascendant Iran, in gas field service and production, but only if their shared field, the South Pars, is developed to mutual export benefit.[26] The pipelines to Europe do not exist, so there is some mutual mistrust between Qatar and Iran that would have to be overcome. Politically, the Qataris are accustomed to approaching regional adversaries with a neutral stance. For Kuwait and Bahrain, there is a stronger tie to Saudi Arabia as a political and military benefactor, and there is the problem of local sectarian politics that can be manipulated to destabilize domestic order.

22 Deal Book, "Revolutionary Guard buys stake in Iran Telecom," *The New York Times*, September 28, 2009. On state-bank links, see also: Najmeh Bozorgmehr, "Iran banks pressed to retreat from asset speculation," *Financial Times*, September 8, 2014.

23 Fred Pleitgen, "For Iran, oil exports matter more than price," *CNN Money*, January 27, 2016.

24 Devika Krishna Kumar, "Oil sinks for second day on fading hopes of output deal, weather," *Reuters*, February 2, 2016.

25 Ladane Nasseri, "Key facts about Iran's economy as red carpets replace sanctions," *Bloomberg Business*, January 28, 2016.

26 "Iran, Qatar in competition over world's biggest gas field," *Natural Gas Europe*, December 23, 2015.

Gulf allies are rightly questioning U.S. strategy toward the region and toward Iran after the JCPOA. There is not a great deal of clarity on expected next steps. The guarantee of “snap back” sanctions offers little reassurance, as the sanctions cannot undo what has been an immediate economic benefit and halo effect created in January. Once investment is placed, the money has changed hands and will be in Iran. Investors stand more to lose by reinstated sanctions than Iran might, at least in the short term.

Conclusion

U.S. leverage is as much with foreign investors to Iran as it is to the Iranian regime itself. The ability to impact the speed and ease of economic liberalization in Iran may be the enduring legacy of the JCPOA and U.S. diplomacy. This is of little comfort to Gulf allies who see the de facto integration of Iran into the global economy as a threat. For some, like Saudi Arabia, the threat is existential. For others, like Oman, Qatar, and, to a degree, the UAE, there are more potential areas of mutual benefit.

For U.S. economic interests, there is a reticence, both in the legality of commercial ties with Iran and the potential risks of lost investment. There are legal avenues for U.S. persons to share in the Iranian exuberance, but only through non-U.S. entities in which they might have an ownership stake with sufficient separation in day-to-day business operations. The longer-term effects will be economic and political ties, built now, which will strengthen European, Chinese, and Russian influence inside Iran.

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