Flashnote

HSBC Global Research

Economics
CEEMEA

Iran deal

What next?

- **Comprehensive accord on Iran's nuclear programme…**
- **…offers substantial relief from trade and capital account restrictions, including limits on its oil industry…**
- **…with December 15 the key date if agreement in principle is to become normalisation in practice**

In this piece we outline the key elements of the agreement reached over Iran's nuclear programme, the timeline for implementation and the substantial obstacles that must be overcome if sanctions are to be lifted and then remain in abeyance. While some trade restrictions will remain in place for a number of years, the accord offers up the prospect of the most damaging measures being lifted in full as soon as December 15 if Iran meets its initial obligations under the accord. This includes extensive relief from restrictions impacting the oil and gas sector, the manufacturing sector, banking, finance and capital markets as well as the unfreezing of foreign assets. We assess the impact this could have on the Iranian economy and its oil sector, and argue that the UAE and Turkey may benefit from first and second round effects of Iranian sanctions relief.

What has happened?

The 14 July accord signed between Iran and the P5+1 (the five permanent members of the UN Security Council (UNSC) and Germany) aims to resolve the dispute over Iran's nuclear programme. Under the terms of the accord, Iran has agreed to measures that the P5+1 believe will prevent Iran from developing a nuclear military capability. Those measures centre on restrictions on weapons-grade fissile material (limits on Iran's capacity to produce highly enriched uranium and plutonium and the destruction of the existing stock) and a regime of intrusive inspections, including access to military sites, to verify that the accord is being adhered to. The restrictions and controls will apply for up to 15 years. Iran will retain the right to develop nuclear technology for civilian purposes under the terms of the non-proliferation treaty to which it is a signatory.

In return, P5+1 have agreed to remove sanctions that had been imposed to curb the development of Iran's nuclear programme. The agreement covers sanctions that have been imposed by three agencies – the US, the EU and the UN – which have targeted trade and capital flows. Other economic and diplomatic sanctions not related to the nuclear programme (such as measures imposed by the US in the 1980s and 1990s after Iran was judged a state sponsor of terrorism) are not impacted by the accord. Diplomatic relations between the US and Iran have not been restored.

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What happens next?

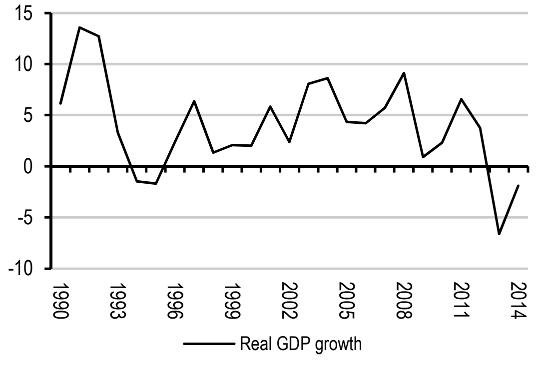
Although approved in principle, the agreement must be approved by each affected body before it is brought into effect. The first will be the UNSC which is expected to vote on a resolution on the terms of the accord in the coming days. Then a Joint Commission representing the p5+1 and the EU will be established to oversee its implementation. Following UN endorsement, the US will then submit the accord to Congress which will have 60 days to review it and then put it to a vote. The EU foreign ministers and the Iranian Majlis (parliament) will also vote on the accord, though the timing of this has not been established

Some members of US Congress have signalled their opposition to the agreement and indicated they will vote against the accord. If the agreement is rejected after the 60-day review period, President Obama has indicated that he will veto the decision and resubmit the accord to Congress. He would be required to do this within 12 days of the vote, at which point Congress would have 10 days to override the president's veto but would require a two-thirds majority. Iran's supreme leader, Ayatollah Khamenei, publicly backed the decision to start negotiations with the P5+1 and has welcomed the accord, suggesting it is likely to be endorsed in the Iranian Majlis.

Provided the accord is approved by all parties, Iran will be required to dismantle facilities capable of producing enriched uranium and destroy its existing stock of weapons-grade fissile material in line with the agreement. It will also have to give the International Atomic Energy Agency (IAEA) a full and comprehensive account of all of its nuclear development activities to date.

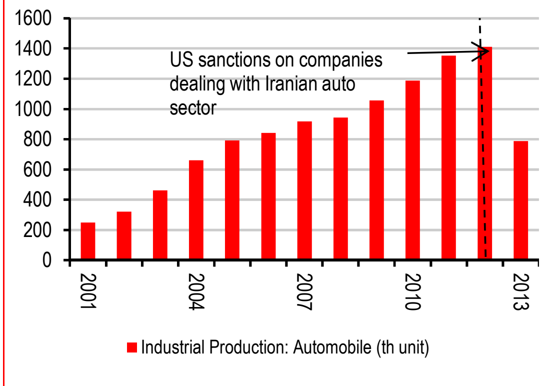
On 15 December 2015, the IAEA will then deliver a report on Iran's adherence to the initial phase of the accord. If it is judged to have cooperated in full, the agreement lifting US, EU and UN sanctions will take effect. If Iran is found by the IAEA to have fallen short, the joint commission will have 30 days to resolve any disagreement before the matter is referred back to the UNSC for adjudication.

1. Sanctions implemented after 2010 have had a particularly severe impact on the Iranian economy (% y-o-y)...



Note: 1 April 2013- 31 March 2014 = 2014
Source: Central Bank of Iran

2. ... with the impact extending beyond the oil sector



Note: 1 April 2013- 31 March 2014 = 2014
Source: Iranian Ministry of Industry

What relief and when?

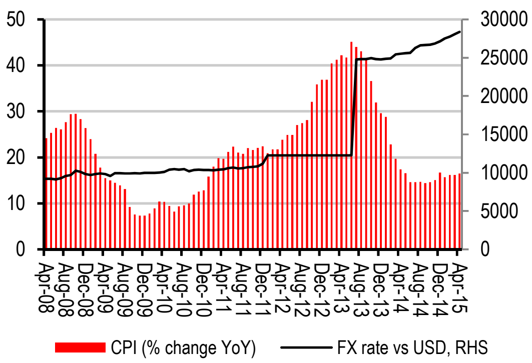
If the IAEA concludes that Iran is meeting its obligations when it reports on 15 December, the agreement provides for immediate relief from all sanctions imposed by the UN in relation to Iran's nuclear programme. However, some EU and US sanctions will remain in place even if the accord is brought into effect. These include measures relating to access to goods that could be used to build a nuclear weapon capability.

The bulk of the US and EU sanctions measures, however, would be suspended immediately. These are listed at length in the accord, together with the relevant legislation and executive orders that brought them into effect. Critically, these include an end to restrictions on:

- Banking transactions including transfers to Iranian individuals, corporates and financial institutions, the establishment of Iranian bank branches overseas, as well as dealings in Iranian Rial
- Access to the SWIFT global payment system
- Financial support for trade services in Iran (including insurance, export credit and guarantees)
- The import of Iranian oil
- Investment in the Iranian oil and gas sector
- Iranian central bank foreign assets
- Investment in Iranian debt
- Trade in gold and other precious metals with Iran
- Trade in goods and services for the automotive sector
- Access to EU airports for Iranian cargo flights, and the sale of civil aircraft and related parts to Iran

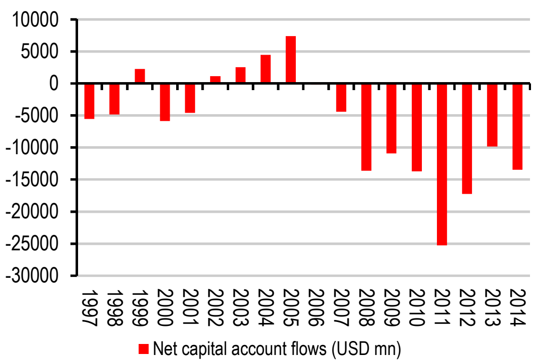
The accord also details Iranian entities and individuals that have been subject to sanctions but would be exempted under the accord. It also requires the US and EU to refrain from taking any steps that might adversely affect the normalisation of economic relations with Iran.

3. Sanctions have led to high inflation and a collapse in the FX rate...



Source: Central Bank of Iran

4. ... as well as large outflows of capital



Note: 1 April 2013- 31 March 2014 = 2014
Source: Central Bank of Iran

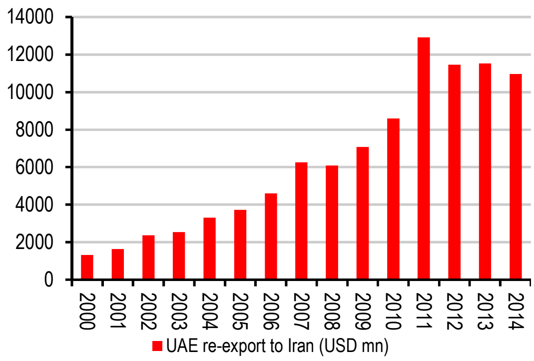
Who benefits?

The obvious beneficiary of the accord would necessarily be **Iran** itself. Macroeconomic data published by the Central Bank of Iran show that Iranian activity has been severely disrupted since sanctions were tightened in 2012 – a downturn that has been compounded by the slump in oil receipts over the past year. Economic growth which had averaged 5.4% per annum in the decade to 2012 subsequently fell to contraction rates of 6.6% and 1.9% in 2012/13 and 2013/14 (April-March year), respectively, led by a marked fall in investment. Inflation has remained at double-digit levels over the past three years, peaking at 45% in 2013 despite the downturn in demand due to the collapse in the value of the Rial. Although Iran has continued to generate a current account surplus, in part as a result of import compression, stricter trade and financial sanctions since 2012 forced the Iranian Rial to lose more than 50% of its value (80% on the black market, by IMF estimates).

The oil sector has borne the brunt of the sanctions disruption especially since the European oil embargo took effect in 2012. Since then, the oil sector's share of GDP has fallen from 25% of GDP to 17%, the budget has lost 25% of its oil revenue, and oil exports have fallen from 2.1 million barrels per day in 2011, to less than 1.7 million barrels in 2013. Industrial sectors have also been severely impacted by recent sanctions. The Central Bank of Iran's industrial production index shows manufacturing contracting by 12% between 2011/12 and 2013/14. Automobile manufacturing – a significant industry in Iran – contracted by more than 40% in 2012/13, after production peaked at above 1.4 million units the previous year.

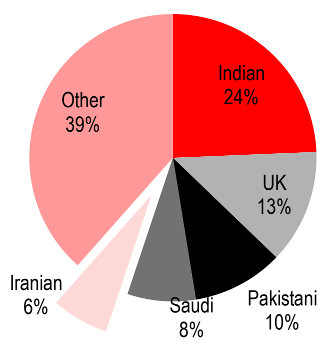
The removal of restrictions that had led to such heavy economic losses would necessarily mark a significant step toward a return to the rates of economic growth that characterised the pre-sanctions era as it would open the way for renewed access to goods, services and capital and allow for some pick-up in sentiment. It may take time, however, for investors both in Iran and overseas to be confident that the sanctions era had definitively drawn to a close, with the threat that restrictions could be quickly re-imposed if Iran is judged not to have complied with international inspectors likely to weigh on confidence. The losses of the sanctions period may also take time to reverse – Iranian banks have seen a surge in NPLs for example, over the sanctions period, and capital levels have fallen. Re-establishing broken trade and financing routes would also take time.

5. UAE re-exports with Iran boomed as economic sanctions became tighter…



Source: UAE National Bureau of Statistics

6. … with Iran's links to Dubai particularly strong
Non-Emirati buyers of real estate in Dubai by nationality in H1 2014 (% share)



Source: Dubai Department of Land

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Iran's key trade partners have shifted over the past decade (USD mn)

2004 Iran top export destinations	Volume	2014 Iran top export destinations	Volume	2004 Iran top sources of imports	Volume	2014 Iran top sources of imports	Volume
Japan	7,515	China	24,968	UAE	5,476	UAE	32,189
China	4,077	India	10,230	Germany	4,114	China	26,772
Italy	2,466	Turkey	8,939	France	2,681	India	4,855
South Africa	2,357	Japan	5,624	Italy	2,359	South Korea	4,578
S. Korea	2,214	South Korea	4,162	S. Korea	1,774	Turkey	4,275
Turkey	1,783	Pakistan	1,637	China	1,623	Germany	3,495
Netherlands	1,660	Syria	1,596	Switzerland	1,462	Italy	1,678
France	1,614	UAE	1,249	India	1,136	Brazil	1,583
Greece	1,296	Saudi Arabia	1,046	Japan	964	Russia	1,460
Spain	979	Oman	539	United Kingdom	943	Argentina	1,143

Source: IMF DOTS

The other immediate beneficiary from any easing of sanctions on Iran may prove to be the **UAE**, or more particularly **Dubai**. Dubai has commercial relationships with Iran dating back over a century and a large and well established Iranian community. The UAE is Iran's biggest source of imports – a reflection less of demand for UAE-produced goods but of the role that the UAE plays as a re-export point for international trade into the Persian state. An easing of trade restrictions could see a greater proportion of goods heading directly to Iran. However, UAE trade routes are well established and a pick-up in Iranian growth would still likely be a boon for UAE traders. Dubai, already the established services hub for the region, would also be a natural place for international firms looking to tap into the Iranian market to set up, particularly given the strength of transport links. Indeed, there are already 16 commercial flights a day from Dubai to a city in Iran, a journey that takes under two hours.

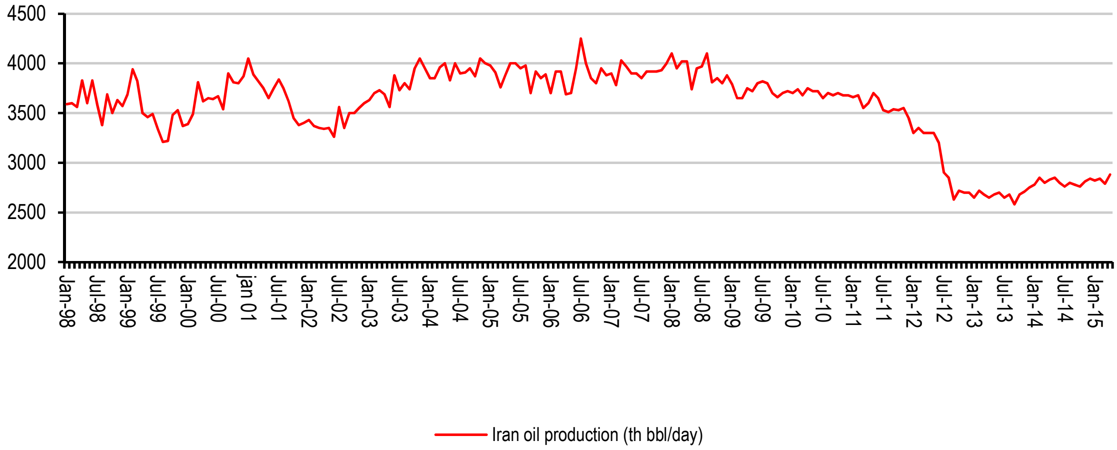
We would also identify **Turkey** as a potential beneficiary of the lifting of sanctions. Most immediately, as an oil importer, Turkey would benefit from any lasting drop in energy prices that accrues from any gain in Iranian oil output. Its proximity to Iran, though, could also allow it to benefit over the longer term from the development of Iranian gas resources, both as a market for these and as a transit route for Iranian gas to Europe. It is also possible that Turkey could seek to develop Iran as a significant export market. With some 75m people on its border and demand for imported goods and infrastructure likely to pick up if restrictions are eased, and particularly if growth accelerates, Turkish firms that have established a significant presence in other parts of the Middle East in recent years stand to benefit.

What does this mean for Iranian oil production?

A full return of Iran to international oil markets could have a material impact on the global market balance. Iranian crude exports have been averaging around 1.1mbd since the current set of US and EU restrictions were implemented in mid-2012, with shipments still going to countries including China, India, Turkey, Japan and South Korea. However, exports were running well above 2mbd before this. Total crude production has dropped from 3.5 mbd in 2011 to around 2.8 mbd in 2014.

It is hard to gauge exactly how much oil could be quickly added to the market if sanctions are lifted. The International Energy Agency (IEA) estimates Iran's crude production capacity at 3.6mbd, but there is a large degree of uncertainty about how well the country's largest, most complex fields have been maintained after years without foreign investment or access to foreign technology. Several years of production curtailment and well shut-ins may have resulted in both reservoir and facility degradation.

7. Oil production is below its peak, with room to grow



Source: IEA

Key published estimates (e.g. Wood Mackenzie, IEA, MEES, IHS) suggest Iran probably has the ability to increase production by around 0.5-0.7mbd from current levels within six months. However, exports could be increased immediately from stockpiles held in floating storage – the IEA believes Iran has approximately 40mb of crude and condensate stored in tankers.

The gains that could be delivered to Iranian production over the longer term are unclear, as is the role that its broader hydrocarbon wealth could play in the global energy market. Increasing capacity would likely require international oil company involvement. Even in the event that the accord is approved, it is difficult to see how there could be significant investment in the oil and gas sector until a positive report is delivered by the IAEA and sanctions are lifted as a result. Investment may also be held back until it is clear that the agreement is likely to hold, that the inspection process is working successfully and that all sides appear to be acting in good faith. Iran's recent experience in working with international firms, together with the demanding terms offered to foreign companies in the pre-sanctions era, may also act as a brake on investment, particularly in an environment of lower oil prices. It is also worth considering the demand side of the equation. As the IEA points out in its latest monthly report, any extra oil supply might be partly offset by increased Iranian demand if the deal leads to improved economic activity. According to BP's latest statistical review, Iran consumes more than 2mbd of oil – almost as much as Germany.

Nevertheless, Iran's oil reserves remain substantial at 157.8 billion barrels – 9.3% of the world's proven reserves according to British Petroleum's data. We also note that Tehran has recently developed a new type of contract called the Iran Petroleum Contract (IPC). The IPC will be offered to international oil companies (IOCs) in lieu of the old 'Buyback' contracts, which were essentially technical service agreements where IOCs were viewed as contractors. As reported by Middle East Economic Survey (MEES), the IPC will contain elements from the generally more favourable Production Sharing Contracts (PSCs), whereby the crude output would be owned by a partnership of the National Iranian Oil Company and the IOC. Iran's gas reserves are more substantial still and sanctions have left development lagging far behind that of Qatar with whom it shares the giant offshore natural gas field. The lifting of sanctions on the import of Iranian hydrocarbons may be of particular note to European markets keen to reduce their current heavy reliance on imports from Russia.

What could still go wrong?

That such a comprehensive agreement has been reached after two years of complex, charged negotiations would appear to point to commitment on all sides, particularly given the high profile support that leaders in Iran and the US have offered. That the accord has been struck against a backdrop characterised by more than 35 years of mutual mistrust since the Iranian revolution (Iran and the US broke off diplomatic relations in 1980) also points to a degree of goodwill, especially given the fierce opposition that US allies in Israel, the Gulf and elsewhere have offered.

But a series of hurdles and risks persist. Most immediately, the accord needs to be endorsed by the EU, Iran and the US, though the support political leaders in each camp have offered suggest that this is likely to take place. The December 15 deadline may prove to be a more significant obstacle. Even if there is goodwill on both sides, the logistics of dismantling enrichment sites and satisfying inspectors that all details of the nuclear programme have been fully disclosed may prove challenging.

Given the magnitude of the issues at stake, it is also likely that the bar will be set high on these initial conditions and for subsequent inspections, especially with the strength of opposition in some quarters likely to mean that scrutiny is intense. The experience of inspection regimes in Iraq before the 2003 US-led invasion only underscores how difficult a lengthy and intrusive monitoring and verification programme can be. Significantly, the July accord is structured to facilitate the re-imposition of sanctions if adherence to the accord breaks down. Specifically, the IAEA are charged under the agreement with reporting to the Joint Commission which has 30 days to resolve disputes. If it is unable to do so, the UN Security Council must pass a resolution for sanctions to remain in abeyance – a structure which prevents a permanent member from using their veto to block restrictions being brought back into force.

Moreover, the accord deals only with the dispute over Iran's nuclear programme, leaving other charged issues untouched. These include Iran's opposition to Israel, its support for Bashar al-Assad in Syria and Houthi rebels in Yemen, as well as its longstanding backing for Hezbollah in Lebanon – positions that continue to place it in direct conflict with the West and that leave it named as a state sponsor of terrorism. Rivalry between Shia Iran and western Sunni Arab allies in the Gulf also remains a potential source of tension.

While apparently contained for now, the unresolved issues inevitably remain risks to the nuclear accord itself that could come into focus should regional tensions rise, or changes of leadership in Iran and the US bring with them a shift in strategic agenda. Indeed, Israeli Prime Minister Benjamin Netanyahu described the agreement as an "historic mistake" and warned that "Israel was not bound by this deal with Iran because Iran continues to seek our destruction". In an official statement, Saudi Arabia welcomed the deal but said that it would look for Iran to "use its resources for domestic development and to improve the living conditions of its people rather than use it to incite turmoil in the region, which would only be met with harsh and determined responses from the countries of the region."

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