

## Three reasons to cut a deal with phased sanctions relief

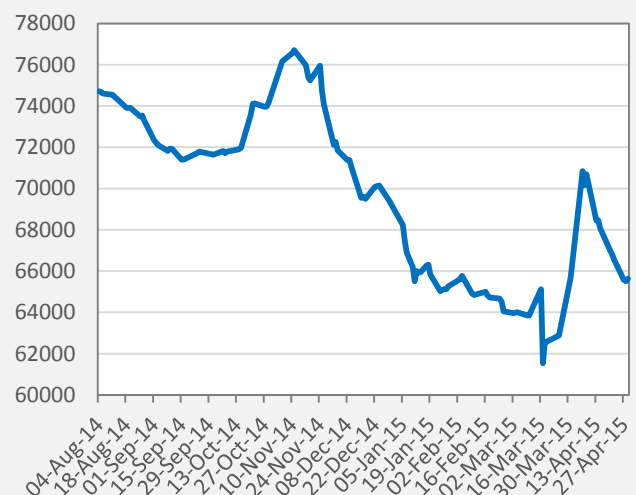
*With the dust settled on April's historic framework agreement, negotiators have re-emerged to thrash out a final deal. But the US and Iranian positions are far apart. Iranian insistence of full and immediate sanctions removal is functional political rhetoric, but fantasy – we suggest three reasons why phased sanctions removal can still pay dividends for Iran.*

**One month on from Iran's historic framework agreement with the P5+1 powers, the markets have little left to show for the uplift in sentiment that occurred in its aftermath.** The TEDPIX stock market ended April at a value close to that with which it started (Fig 1). The market exchange rate of the rial plateaued after a small uptick at the start of the month (Fig 2). Markets are conscious of the considerable challenges that stand in the way of a comprehensive deal.

**Iran's most senior figures have claimed in chorus that there will be no deal unless it is accompanied by immediate and full sanctions removal.** Such dogmatism is understandable in the domestic political context as a rhetorical tool to keep Iran's "hard-line" factions engaged. Indeed, the negativity was mirrored in the US, as the White House allowed Congress the right to review a final nuclear deal. It is a familiar pattern in these nuclear talks to allow a small step backwards after any progress made; the substantial leap forward achieved on 2<sup>nd</sup> April is no exception.

**Demands for full and immediate sanctions removal are fantasy; but phased relief would deliver substantial rewards to the Iranian economy.** Only eight weeks remain for negotiators to resolve their differences and the timing of sanctions removal is a high-profile stumbling block. If Iran could flex its interpretation of *the deal it could accept*, VerityIran economists anticipate substantial dividends for the

**Fig 1. TEDPIX Stock index**  
(August 2014 to present)



**Fig 2 Rial:USD exchange rate (market and official)**  
(December 2014 to present)



Iranian economy for three reasons.

***Reason 1: If talks break down, Iran's isolation from the global finance and trading system will get worse, not better.***

President Rouhani claimed in a 16 April press conference that even if an agreement was not reached, the structure of sanctions as we know it will not be as stringent as in the past. The Governor of the Central Bank of Iran (CBI) has claimed that economic planning is based on a no-deal scenario, under which the economy would feel a gradual improvement. Neither should underestimate the willpower of the US political system to increase the economic pain for Iran should they see no sign of progress. Even with no new sanctions, the sheer weight of inertia of the existing sanctions framework – the most comprehensive and far reaching in history – means Iran's old international business partners will continue to avoid the risk and inconvenience of dealing with Iran for years to come.

***Reason 2: Failing to reach a deal would be a catastrophic waste of economic potential in the Islamic Republic.***

If talks breakdown, VerityIran economists expect to see a rush to the exit from Iranian capital holders, educated youth and internationally minded businesses. The Central Bank would scramble to impose restrictions on capital flows and shut down the stock exchange and money exchanges. Investment and consumer spending would seize up, bursting the bubble of expectation that has inflated over the past two months. In such a scenario, the banks would be acutely vulnerable to insolvency as the demand for withdrawals and the failure to meet loan repayments spike. Authorities would be faced with the policy dilemma of inflationary stimulus or austerity. Even the former would be ineffective in resolving a complex stagflationary crisis, and would do little to resolve the pressures on bank lending. Millions of ordinary Iranian households would see their lives get harder as their purchasing power came under renewed pressure from unemployment, rising import costs and inflation. With 42% of University graduates jobless, according to Majlis Speaker, Larijani, the most significant costs to Iran will fall not in 2015, but in the lost decade of progress for Iran's large, educated and potentially vibrant economy.

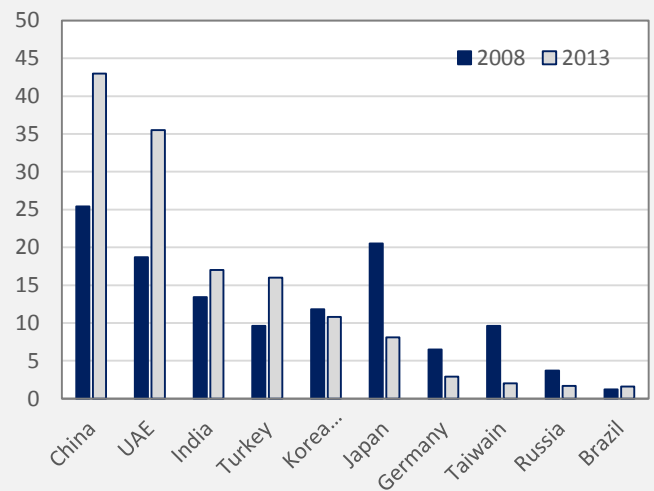
***Reason 3: Phased sanctions relief would still deliver sufficient benefit to the Iranian economy to steer it onto a sustainable growth path.***

A deal on 30<sup>th</sup> June would have an immediate positive impact on the Iranian economy as domestic and international investors alter their risk assessments and pour into Tehran's capital and equity markets. There has also been speculation of a multi-billion dollar "signing bonus" in sanctions relief, should a deal go through. In the following months we would see a healthy rise in consumption as a stronger rial lowered the cost of imports, demand for Iranian exports began to climb, and Iranian households began to save less and spend more. This would be combined with a prolonged uplift in investment, following years of neglect in Iranian industry. International investors are queuing up to buy into the resurgent economy. The government has programmes in place to attract US\$30bn of Foreign Direct Investment from Iran's large pool of expats, who a recent report suggested had a net worth of US\$1.3 trillion.



If “phased sanctions relief” meant a monthly quota on the repatriation of Iran’s frozen assets, a sliding scale on Iran’s permissible oil and petrochemical exports, and a staggered de-listing of Iranian financial entities, then all of the above benefits would still apply, but would be spread out over a year or two. Iran’s Economy Minister and Central Bank Chief have always been careful to warn Iranian citizens of the risks of sanctions relief, through volatility and inflation. Indeed, phasing the removal of sanctions after a period of prolonged and acute isolation from international finance may prove a blessing in disguise. With sentiment about the future of the economy in a much healthier state, the authorities could go about establishing a sustainable medium term plan to recapitalise the banking sector, restore order to government balance sheets, prioritise key infrastructure and weed out a culture of corruption through state organisations, without jeopardising growth.

**Fig 3. Iran’s major trading partners**  
Top 10 trading partners (exports and imports) \$bn, 2013

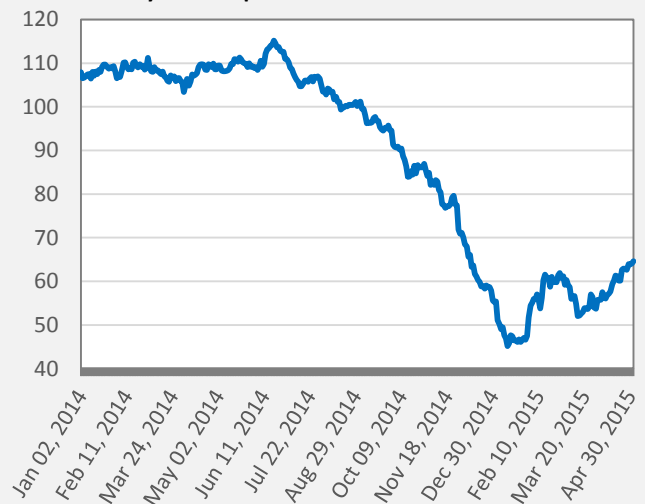


**Private banks in Iran agreed to cooperate on a 20% deposit rate ceiling this month, which represents a 2% reduction from the existing rate.** Proponents suggest cheaper lending rates are required to revive Iran’s suffering industries and to divert savings to more productive areas of the economy. However detractors worry that as the lending would likely funnel directly into current expenditure, it would stoke inflation. CBI governor Seif himself identified the frailties of the Iranian banking system. The main obstacle to business lending is not the rate of interest, but the crowding out of government borrowing and the poor capital base. Government debt to commercial lenders is worth around 90 trillion tomans (c. US\$36bn) and NPLs around 100 trillion tomans (US\$40bn). Tayebnia and Seif have both said on different occasions that if the government does not maintain its own payments, the banking system will not be able to provide the credit required to instigate economic growth.

**Symbolic Russian and Turkish trade deals this month mark a continuation of Iran’s vision to rebalance its economic model.**

Turkish President Erdogan announced a desire to more than double trade with Iran to US\$30bn in a bilateral “Economic cooperation” agreement. Erdogan believes that the prospect of Iranian gas sales to Europe in a post-sanctions environment aligns with his vision of Turkey as a strategic energy hub for the region. Turkey-Iran trade has boomed in the past five years (Fig 3) as Western imports have been diverted through a porous Turkish border. Meanwhile Russia’s Deputy Foreign Minister Ryabkov said strategic barter trade with Iran had begun and is working well. According to Ryabkov, a “considerable volume of goods” was being delivered to Iran, in exchange for Iranian crude, although no figures were provided.

**Fig 4. Brent crude oil price (\$pbl)**  
January 2014 to present



***The Central Bank of Iran also apparently agreed a currency swap arrangements with both countries to facilitate trade in Rial, Lira and Rouble.*** Such a deal is the first requirement for bilateral trade to be denominated in any given currency. But such transactions are unlikely to displace hard currencies like the US dollar, Euro and Yen any time soon. Obstacles will include a lack of liquidity, heightened exchange rate risk and a lack of participating banks. Most importantly, exporting in minor currencies is an inconvenience to businesses and hence costs money. If the arrangement does thrive it will be a strong sign that Iranian businesses remain so isolated they are willing to lose money over traded goods.

***A US\$0.10 recovery in (Brent crude) oil prices in the past month has offered some respite to Iran's beleaguered oil sector (Fig 4).*** But with revenues down and budgets stretched, NIOC and the Oil Ministry have both turned on the subsidy reform programme. The Oil Ministry currently pays up to IRR 35,500tr (over US\$1bn) per month in cash hand-outs to Iranian households. NIOC announced it has debt of more than \$50bn and was paying US\$10.21bn a year out to cash compensation schemes.

