What is happening in Iran?

A survey of recent events and why they matter for international markets

Key takeaways:

- Iran's economy recovered spectacularly in 2016, after sanctions were lifted.
- But lately, high inflation and unemployment have fueled street protests.
- What's more, the Trump administration has threatened to reimpose sanctions, which could not only gravely hurt Iran's economy, but also bring turmoil to oil markets and, consequently, more volatility to financial markets.
- Even if things are sorted out, risks are now considerably higher than just a year ago; also, great damage has been done to long-term oil supply, as a result of lower current investment in the oil industry throughout the Middle East.

Two reasons explain why Iran has featured so prominently in the news lately. First, the largest protests against the government since 2009; second, the Trump administration's threat to tear up the nuclear deal that the previous administration – alongside major allies – had reached with Iran. Although Iran is definitely not one of the top destinations for U.S. investment, its outsized role in oil markets – plus the effect a (more) destabilized Middle East would have on the price of crude – makes the situation there a geopolitical problem that could have great impact on the worldwide economy and equity markets, in particular. In this commentary, we briefly review both subjects, discussing potential consequences for markets in 2018. We conclude that the situation is not as worrying as it was before 2015, but the stakes are higher than they have ever been since President Trump's inauguration more than a year ago.

Why is the situation in Iran important?

In a recent presentation (February 22nd, 2018), Bassam Fattouh, of the Oxford Institute for Energy Studies – an independent center of the University of Oxford –, discussed the general deterioration in geopolitical conditions in the MENA region (Middle East and North Africa). Borders are being redrawn; some governments lack the necessary legitimacy to govern effectively, prompting the rise of parallel groups to fill the void; and regional conflicts between different powers within the region (and also outside, fighting proxy wars), are all conspiring against investment in the oil industry. What Mr. Fattouh argues is that the effects of this lack of investment have not yet impacted oil markets. On the one hand, output has recovered in Libya (although not to its pre-2011 levels), Nigeria, and Iran ¬(after sanctions were lifted in 2015). On the other, U.S. shale has boosted supply considerably. But this will not be enough in the long run. As the oil market tightens, more OPEC output will be needed. The IEA (International Energy Agency) has already warned that shale will not be capable, on itself, of satisfying future demand. (This may come as a surprise given that in February crude production in the U.S. hit a record, 10.27 million barrels per day, surpassing Saudi Arabia and inching close to Russia, the top producer.) Therefore, the turmoil that is hindering investments in Iran, the Kurdistan, Libya, and others (plus the grim outlook in Venezuela) may have much broader economic consequences in a few years.

What happened recently?

On Thursday, December 28th, a protest movement erupted in Iran, on a scale the country had not seen at least since 2009. That year thousands of people protested after the reelection of Mahmoud Ahmadinejad, an electoral process they deemed rigged. The 2009 movement – which came to be known as the Iranian Green Movement – had the capital Tehran as its epicenter and students as the main protagonists. This time, however, protests started in Mashhad the country's second largest city. Despite the restrictions on the free flow of information, which included internet censorship for a few days, the accounts coming from Iran suggest that this time the key driver behind the protests was economic discontent. Among the factors fueling dissatisfaction are: (*i*) increased unemployment; (*ii*) higher prices; (*iii*) the elimination of certain government subsidies; (*iv*) corruption; and (*v*) the vast amount of resources the country devotes to supporting foreign governments and groups. As the movement spread to other cities, it started to acquire a more political character. Although the protests seem to be over, in no minor part because of swift action by government forces, it is worth assessing the long-run implications of this (apparently) short-lived movement.

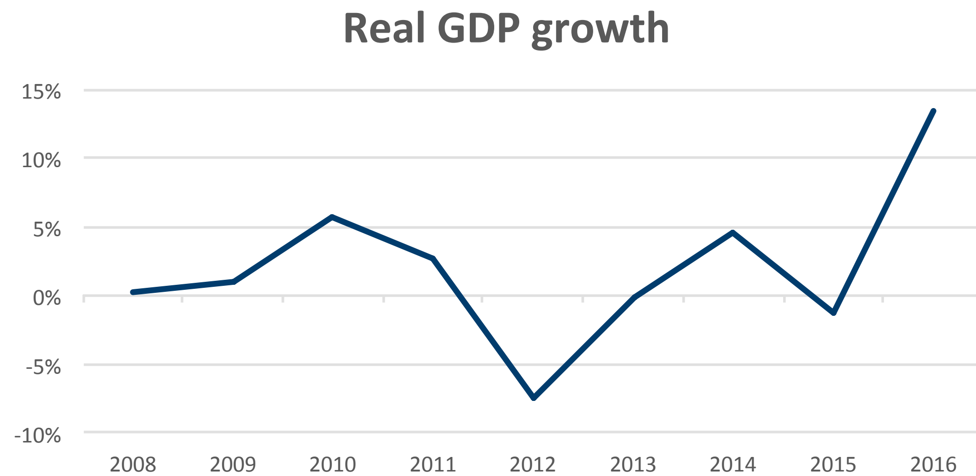
Protests and sanctions are intertwined

Economic frustration amongst the Iranian population is supported by the available data. More importantly, this means the source of discontent is still very much alive, and new demonstrations could erupt at any time. If we look at GDP (figure 1), the violent contraction of 2012 immediately stands out. After that, 2013 and 2015 also brought negative growth rates, setting the country back a few years in terms of economic output. This was in great part due to the international sanctions imposed on the country for its pursuit of a nuclear program under the administration of President Mahmoud Ahmadinejad (2005-13). Only after President Hassan Rouhani – a moderate who has been in office since 2013, and was reelected in 2017 – struck a deal in 2015 with Western powers (US, Russia, China, UK, France, and Germany) were the sanctions lifted in January of 2016. This happened immediately after the International Atomic Energy Agency (IAEA) certified Iranian

Figure 1

GDP HAS BOUNCED BACK IN RECENT YEARS AFTER THE SANCTIONS CRIPPLED IRAN'S ECONOMY.

Source: Innealta Capital using data from The World Bank.



compliance (basically, a reduction of their nuclear program that will render it impossible for them to build nuclear weapons). The economic consequences were immediately felt, as GDP bounced back with a spectacular growth rate of 12.5% (IMF). Natural resources (oil and gas, mainly) played a big part in this economic resurgence. This is not surprising: sanctions crippled the Iranian oil industry, costing an estimated $160 billion to the country in revenues between 2012 and 2016. The lifting of sanctions attached to the nuclear deal allowed Iran to reenter international oil markets. Furthermore, the country regained access to the SWIFT system and other parts of the global financial system essential for international trade. Finally, it gave back Iran control of approximately $100 billion in assets that were frozen in foreign banks.

In spite of the surge in output, the unemployment and inflation rates still cast doubt on the strength of the recovery, providing solid evidence that economic factors played a major role in the protests that we recently witnessed (figures 2 and 3). Despite spectacular growth in 2016, the unemployment rate actually rose, reaching 12.5%. During 2017, the rate continued to hover around 12%. As for inflation, it slowed down in 2016, but it was still very high (9.03%), especially considering that central banks in many countries were (and still are) deploying different tactics to actually boost prices. In December of 2017, the year-on-year inflation rate stood at 10%, showing that the inflation problem is far from over.

In terms of future prospects, the IMF has a positive overall outlook on the country's economy: it projects that real GDP will grow by 3.5% in 2017, 3.8% in 2018, and 4.1% in 2022. But as long as inflation and unemployment remain high, economic growth may not be enough.

Figure 2

INFLATION WAS RAMPANT JUST A FEW YEARS AGO. THE SITUATION HAS IMPROVED SUBSTANTIALLY, HOWEVER.

Source: Innealta Capital using data from the IMF.

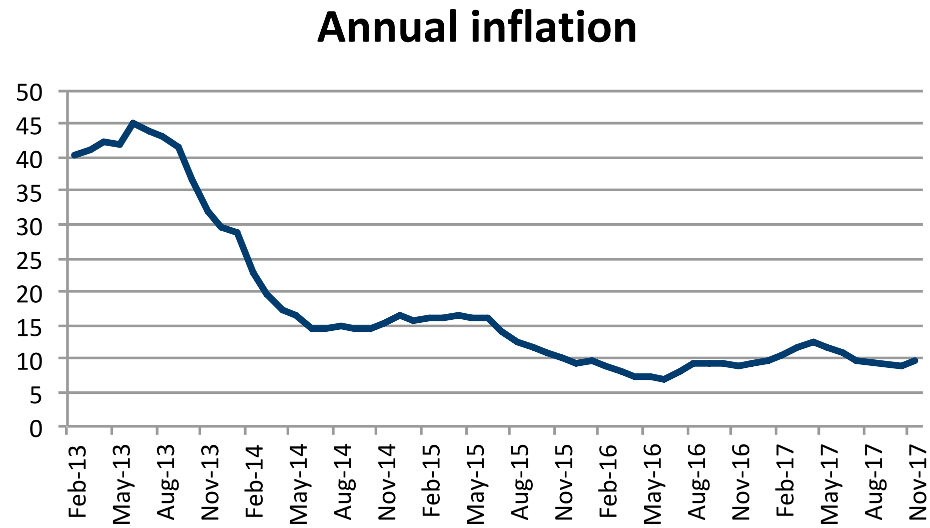
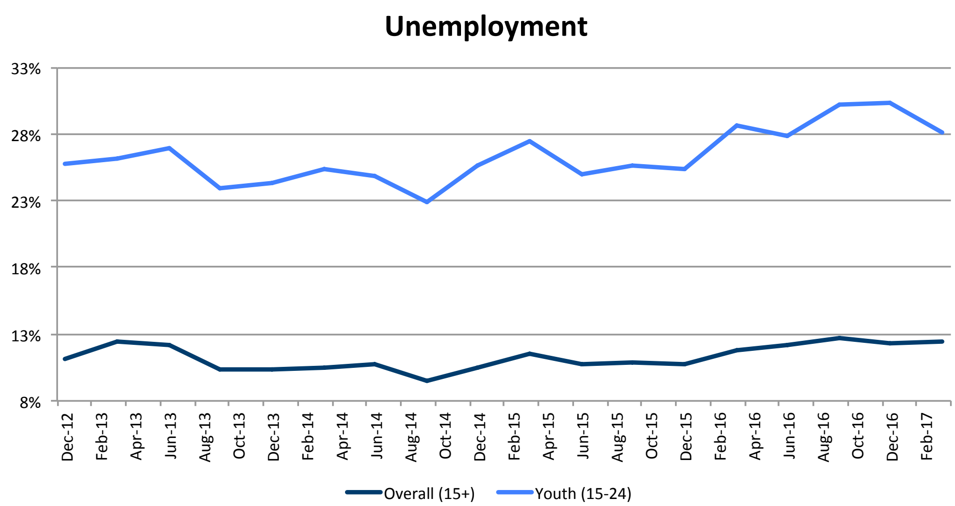


Figure 3

A BIGGER PROBLEM IS UNEMPLOYMENT, ESPECIALLY AMONGST THE YOUNG.

Source: Innealta Capital using data from the Statistical Centre of Iran.



Could sanctions be brought back?

In spite of most sanctions having been lifted, the U.S. has kept in place financial sanctions. Some of them go back to 1979, after the hostage crisis at the U.S. embassy in Tehran. Financial sanctions have discouraged foreign investment in the country. But what has many analysts wondering now is whether the sanctions that were indeed lifted after the 2015 deal could be re-imposed. These fears stem from the fact that President Trump thrashed the accord while campaigning for the presidency ("the worst deal ever," "an embarrassment," "incompetently negotiated"). While he has not yet withdrawn the U.S. from the agreement, he moved a step closer last October. His administration disavowed the Iran deal that month, refusing to certify Iran's compliance with the terms of the deal. It had done so twice before, nonetheless. (Congress passed a law in 2015 requiring the administration to certify compliance every 90 days. Certification is not part of the deal itself, meaning decertification does not equal withdrawal.) It went even further, stating the U.S. would pull out unless the accord were amended. The U.K., Germany, France, and Iran itself have made clear they do not intend to renegotiate the terms. In that case, the U.S. could still scrap the agreement unilaterally by re-imposing sanctions, yet at this point it seems unlikely that Congress will support this. Congress matters because it has the power – yet not the obligation – to fast-track legislation to slap sanctions back on Iran if the administration does not certify compliance with the nuclear deal. What's more, all that's needed is a majority in both chambers, which are under Republican control. If Congress chose to go down that path, the deal would very likely fall apart. Collapse may still happen without Congress's involvement, albeit more slowly, if decertification persists.

Potential consequences

For now, it seems decertification was a symbolic move, as we have not seen the administration urge Congress to re-impose sanctions. The secretary of defense has stated he believes the deal to be in the U.S.'s national-security interests. Congress could nevertheless act on its own, but we haven't seen any signs that Republicans are actually considering this, even if they voiced opposition to the agreement when it was reached more than two years ago. Moreover, a few weeks ago, on January 12th, the president said he would not be re-imposing sanctions for the time being. Yet he stated he would next time unless material changes to the pact are made. Beyond the sanctions under the scope of Congress, there is an extra set for which the U.S. president issues temporary waivers (as part of the deal), something that has not failed to happen so far. However, this provides the administration with another avenue that would lead to the effective termination of the agreement.

If the deal were canceled, the consequences would be immediately felt. The Middle East would become even more unstable, especially if Iran resumes its nuclear program and starts approaching nuclear-weapon-making capabilities. Many analysts fear that Israel could preemptively strike Iranian nuclear facilities in such a scenario. Additionally, if protestors came back to the streets, be it for economic or political reasons, this could propel the U.S. government to take a harsher stance against Iran. That has usually involved economic sanctions in the past, which this time around would also probably unravel the nuclear deal.

The first effects of sanctions would most likely be visible in oil markets. However, they would depend on how many countries decide to join the U.S. in, for example, banning or reducing oil imports from Iran. And it is unlikely that China and many European countries would join such a move, meaning the ripples would not be considerable. The sanctions that were lifted in 2015, when the U.S. and Europe were coordinated, had a major impact in Iran's oil exports. Exports took a big hit in 2011 because of sanctions, only reaching pre-sanctions-era levels in 2016 (approximately 4 million barrels per day). That scenario seems unlikely to return, unless Iran were to violate the terms of the nuclear pact (which, again, seems improbable). Under an oil embargo, however, Iran could even raise the stakes by threatening to close the Strait of Hormuz, a vital route for oil exported to the West (around 20% of worldwide trade in 2011, roughly 17 million barrels). Iran already made this threat in 2012, and some analysts believed Western powers would have resorted to force to keep it open. Needless to say, a standoff like that would likely send oil prices soaring.

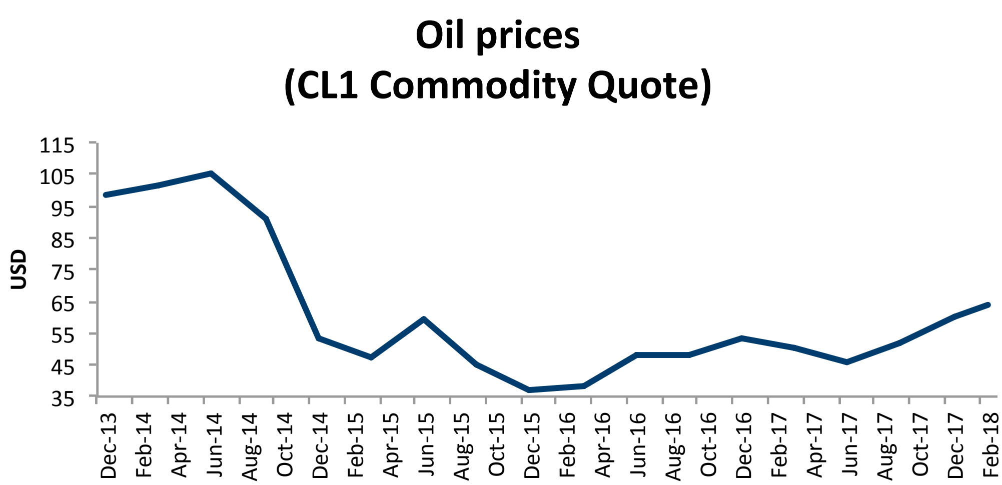
Finally, it is important to note that Iran is not the only major oil exporter currently exposed to potential U.S. sanctions. Last month, during a visit to Argentina, Rex Tillerson, the United States' Secretary of State, said the administration was considering sanction to Venezuelan oil exports in light of the current political crisis there. Venezuela is the third largest oil provider to the United States.

Global supply of oil has been tightened since January of 2017 by OPEC and allies like Russia, which have decided to reduce output in order to increase prices. This has been achieved: oil has reached a three-year record price (around $70/barrel). If Iran's output is forcibly reduced – as it was by the previous set of sanctions, by approximately one-half – we can expect prices to keep creeping up. In any case, the current uncertainty is already causing damage, for it makes it harder for Iran to attract foreign investment that would allow it to increase oil production, and hence oil exports.

Figure 4

OIL PRICES HAVE BEEN ON THE RISE.

Source: Innealta Capital using quarterly data from Bloomberg.



Conclusion

The sanctions imposed against Iran definitely damaged its economy and were probably one of the reasons why the country ended up cutting a deal with Western powers to halt its nuclear program. However, the fact that the Trump administration is threatening to either walk out of the deal or impose new sanctions will deter foreign companies, including banks, from investing and doing business in Iran. Most importantly, this would probably end up destroying the nuclear agreement. Such a scenario would bring about renewed tensions in an already turbulent region. The biggest fear is that a more developed nuclear program in Iran could drive Israel to launch a preemptive attack. As expected, any increase in the probability of such an outcome will have an effect on oil prices, as we have seen many times in recent decades. Hence, any action by the Trump administration that undermines the accord signed in 2015 will probably reflect on oil prices. For now, we believe it is more likely than not that the agreement will remain in place. But given the rhetoric displayed during President Trump's campaign for the presidency, plus the fact that he recently refused to certify Iran's compliance with its part of the deal, we remain cautious. As for the return of street protests, there is not enough information to make an assessment as to whether they will resume at some point or not. For markets, the main risk is that the government's reaction to them may lead to more tensions with the West. Uncertainty regarding Iran is not dissipating any time soon. For the long-term, the effects of current geopolitical instability in Iran and the Middle East and North Africa, that have hurt investment in the oil industry, will manifest in reduced supply and tighter markets. The fact that Saudi Arabia, the de facto leader of OPEC, has recently stated it will continue withholding output, adds an extra layer of uncertainty into the future of oil markets.

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