Sanctions Relief: What did Iran Get?

By Paul Domjan, Mark Dubowitz, Jennifer Hsieh, and Rachel Ziemba

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Forward by Mark Dubowitz[1]

We have written extensively on the role of sanctions relief on Iran's economy and on the impact of this relief on Iranian negotiating leverage.[2] While it is widely accepted that painful financial and energy sanctions played a major role in persuading Iran to engage in more serious negotiations with the P5+1 over its nuclear program, there has been a vigorous debate in Washington, and in other key capitals, over what policy choice would be more likely to lead to a final "good deal" that effectively curtails Iran's military-nuclear and ballistic missile programs: enhanced economic pressure, through the threat of new sanctions with strict deadlines to reach a comprehensive agreement, or the provision of direct sanctions relief in exchange for limited nuclear concessions as part of an interim agreement.

"Painful financial and energy sanctions played a major role in persuading Iran to engage in more serious negotiations with the P5+1 over its nuclear program."

That policy choice was made by the Obama administration, which decided to de-escalate the economic pressure in mid-2013 around the time of the election of President Hassan Rouhani, including by using the threat of its veto to stall new congressional legislation that would have imposed new sanctions. The administration then reached an interim plan with Iran, the Joint Plan of Action (JPOA), in November 2013, and an agreement to implement the plan in January 2014. The Obama administration has claimed that it "halted the progress of" and "rolled back" "key parts of" Iran's nuclear program, a claim disputed by a number of experts, in exchange for "limited, temporary, targeted, and reversible" sanctions relief.[3]

1. This analysis is coauthored by the Foundation of Defense of Democracies and Roubini Global Economics. As an independent economics research firm, Roubini Global Economics does not take a view on what policy the U.S. should adopt with respect to Iran.
2. "FDD Reports: The Effect of Sanctions Relief on Iran's Economy," *Foundation for Defense of Democracies Website*, accessed July 11, 2014. (http://www.defenddemocracy.org/fdd-reports1/)

3. Barack Obama, "Statement By The President On First Step Agreement On Iran's Nuclear Program," *The White House*, November 23, 2013; (http://www.whitehouse.gov/the-press-office/2013/11/23/statement-president-first-step-agreement-irans-nuclear-program) & Robert Satloff, "Iran's Nuclear Program Is Still Growing, and America's Fist Is Shrinking," *New Republic*, November 25, 2013; (http://www.washingtoninstitute.org/policy-analysis/view/irans-nuclear-program-is-still-growing-and-americas-fist-is-shrinking) & Erich Follath, "Olli Heinonen on Iran: 'This Is a Step Forward, Without a Doubt,'" *Speigel Online International* (Germany), December 2, 2013; (http://www.spiegel.de/international/world/former-iaea-nuclear-expert-olli-heinonen-discusses-pitfalls-in-iran-deal-a-936628.html) & Mark Dubowitz & Orde Kittrie, "A Weak Agreement Likely To Get Worse," *The Wall Street Journal*, November 24, 2013; (http://www.defenddemocracy.org/media-hit/a-weak-agreement-likely-to-get-worse/) & The White House, Press Release, "Fact Sheet: First Step Understandings Regarding the Islamic Republic of Iran's Nuclear Program," November 23, 2013;

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Meanwhile according to President Obama, if Iran proved unwilling to reach a final agreement, it would not be "… hard for us to turn the dials back or strengthen sanctions even further."[4]

Now, six months after the implementation of the JPOA and twelve months after the White House's decision to de-escalate the sanctions pressure, we decided to take another look at the impact of these decisions on Iran's economy. We wanted to contribute to the important debate over the question: "What did Iran get?" as a result of a White House decision, knowingly or unwittingly, to diminish the economic pressure.

We ask the question this way because too much of the Washington debate has been dominated by an artificial distinction between "direct" and "indirect" sanctions relief and a desire to express both of them in dollar terms. In our view, what is most important is what Iran received in the form of economic benefits, both direct and indirect, and what if any impact these benefits have on Iranian negotiating leverage. This is not only an important policy debate about the past: We are concerned that, if the P5+1 and Iran fail to reach a final agreement by July 20, 2014, and the JPOA is extended for additional time, Iran will demand that it should be compensated with greater direct sanctions relief in exchange for this extension.

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Tehran has a strong rhetorical case to make to support this demand since the White House has taken great pains to minimize the value of the indirect economic relief that Iran received as a result of the JPOA. As we argue, Iran, and for that matter the White House, has a much weaker case to make based on economics: Iran has received significant relief – both direct and indirect – and it is experiencing a modest, albeit fragile, recovery as a result. While the Iranian economy remains under pressure, its stabilization and improvement in key areas has enhanced Iranian negotiating leverage. We fear that this has made it more difficult for Washington and its partners to reach a final agreement that peacefully prevents Iran from acquiring a nuclear weapons capability.

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Executive Abstract

This study seeks to answer the question: How much benefit has Iran derived from sanctions relief? We have found that:

- ***From a narrow accounting perspective, we estimate that the external earnings and assets associated with sanctions relief amount to about $11 billion in the six months of the JPOA period.*** This amount includes additional petroleum and non-oil export earnings of around $7 billion and access to $4.2 billion in foreign exchange (FX) reserves. ***This compares to the Obama administration's estimate of $7 billion in total direct relief.***

(http://www.whitehouse.gov/the-press-office/2013/11/23/fact-sheet-first-step-understandings-regarding-islamic-republic-iran-s-n)

4. Josh Gerstein, "Obama Speaks Out Against More Iran Sanctions," *Politico*, December 20, 2013. (http://www.whitehouse.gov/the-press-office/2013/11/23/fact-sheet-first-step-understandings-regarding-islamic-republic-iran-s-n)

- The dominance of condensate exports within Iran's oil exports growth this year has increased Iran's energy output and supported growth. ***Condensate revenues are automatically transferred to restricted escrow accounts and therefore cannot be used build up accessible foreign assets or to finance imports apart from humanitarian goods and permissible imports through bilateral trade arrangements with Iran's oil customers. However, as a recent Iranian money laundering and sanctions scheme in Turkey suggests, even these escrow restrictions, which have restricted the use of much of Iran's overseas funds, are not airtight.***

- ***The value to the Iranian economy of sanctions relief is much greater than the direct increase in FX assets and earnings suggests since it ignores domestic benefits including employment growth.*** This domestic benefit can be summarized as a stronger currency, more moderate inflation, and an economy that we forecast to grow 2% in FY 2014/15 rather than contract as it has in previous years when sanctions were escalating. ***These benefits include some breathing space that has allowed Iranian officials to maintain tighter monetary and fiscal policy to strengthen the rial and temper inflation, which has stabilized at just under 20%.***

- These benefits exceed the value of the specific items of sanctions relief and reflect a general shift in sentiment and a change in the sanctions environment. Since mid-2013, ***we have witnessed a de-escalation of sanctions pressure and improvement in international and domestic sentiment towards the Iranian economy, which in part reflects a shift towards tighter fiscal and monetary policy which helped strengthen the Iranian rial.*** Improved sentiment encourages international actors to increase their willingness to engage in business with Iran (including providing Iranian entities greater access to their savings) and makes domestic actors more likely to consume or invest, rather than hoard hard assets, like gold and real estate.

- It takes time for both specific items of sanctions relief and improved sentiment to feed through to economic growth. For example, in order for the suspension of sanctions on imports of auto parts to impact employment, domestic consumption, and GDP, parts need to be imported, production facilities need to be reopened, staff needs to be rehired and trained, and cars need to be produced and sold domestically. In the financial sector, compliance groups need to assess the new regulations and the counterparty risk of Iranian recipients. Because of these lags, we estimate that if the terms of the JPOA were extended, the benefit felt in the second six months would be much greater than that felt in the first six months even if no additional relief were provided as part of this extension.

- Finally, ***sanctions relief has helped Iranian authorities build up resilience against future shocks. Although the government began its interest rate and fiscal adjustment before sanctions relief kicked in, the improving external environment created more space for the government to do fiscal consolidation without exacerbating the recession.*** Iranian authorities so far have preferred to use the breathing room created by sanctions relief to build economic resilience than to maximize economic growth by, for example, accumulating reserves and savings and maintaining their fiscal consolidation approach. These policies make Iran more able to cope with any future sanctions, should they materialize.

This final point is particularly important: ultimately, the impact of sanctions relief is a function both of the relief that is given and the way that Iran chooses to use that relief. For example, a sanctions relief provision that allows for the resumption in imports of auto parts only promotes economic growth since auto parts are used to build cars for domestic consumption and cannot be used to build reserves. By contrast, relief that involves giving Iran access to assets can be used in either way: Iran can choose to spend the assets on imports and much needed investment or bank them to build reserves and economic resilience. In developing future policy, policymakers may wish to consider how specific sanctions relief measures might impact both economic growth and economic resilience.

This report is designed to help provide policymakers with the tools to better assess the benefits accrued from the reversal of sanctions momentum over the last year, along with the improvement in sentiment within Iran and among outside investors. This report is divided into two sections: (1) an accounting exercise concerning the increase in oil export revenues and access to reserves; and, (2) an update of economic forecasts that assess the indirect effects on Iran's economy of the shift in sentiment and other benefits from the changing sanctions environment. Iran's recession appears to have bottomed out in 2013, and the economy began to expand on a year-over-year basis in 2014.

Contrary to the Obama administration's claim that Iran's economy faces persistent and damaging economic pressure, the combination of improved market sentiment, the gradual increase in oil output, and Tehran's access to some of its foreign assets has provided breathing space to Iran's economy and especially its leadership. The most significant impact of the sanctions relief has likely come as a result of increasing oil exports (including condensates) to key Asian economies (China and India), with the suspension of sector specific sanctions also providing a boost through facilitating imports into Iran. As the suspension of financial, precious metals, and sector-based restrictions and other elements of sanctions relief took time to have an impact, we expect their favorable influence on Iran's economy will grow in the coming months – even if no agreement is reached by July 20 and the JPOA is extended for six months with no additional sanctions relief as part of the extension.

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Given the volatility of the rial over the last two years, coupled with the increase in foreign revenues from sanctions relief, it is more instructive to express the indirect benefits from sanctions relief and improved sentiment in inflation-adjusted economic output terms (in rial rather than in USD). While elements of the JPOA have increased Iran's ability to access more of its foreign assets and can thus be expressed in dollars, the bulk of the economic benefit is reflected in increased economic output and improvements in employment within Iran. The combination of energy, precious metals, and petrochemical sanctions suspensions and $4.2 billion in direct cash relief – valued by the administration at approximately $7 billion and, by our assessment, at about $11 billion in the last six months – has helped boost imports and facilitated domestic production, which will favorably impact employment levels. Meanwhile, currency adjustments and improved market confidence domestically have reduced asset bubbles and hoarding activity, which should increase consumption and fixed investment potential. The combination of improved sentiment, better domestic policy, and sanctions relief has helped the economy move from recession into expansion (as of early 2014). With the delayed impact of the sanctions relief package, we expect these phenomena will build in the coming months.

Key Findings

- ***Sanctions De-Escalation Has Helped Iran's Economy Recover:*** The Obama administration's decision to de-escalate sanctions pressure in mid-2013, and the direct sanctions relief provided as part of the JPOA, helped lead to an improvement in Iranian domestic sentiment, an increase in earning power, and a modest, albeit fragile, economy recovery from the depths of the 2012 and early-2013 recession. Moreover, with some of the JPOA sanctions relief measures only just recently coming into effect and starting to boost employment and economic output, we expect that the economic benefits will only grow in the coming months, even if the talks are extended without any additional sanctions relief.

- ***Enforcement of Existing Sanctions has Fallen:*** Despite statements from President Obama and administration officials that existing sanctions would be "vigorously" enforced, there has been a notable decrease in the number of designations.[5] No new sanctions have been imposed since July 1, 2013, when the *Iran Freedom and Counter-Proliferation Act of 2012* came into effect,[6] and there has been a significant reduction in entities designated by the United States. In the twelve months before the election of President Rouhani, 183 entities were designated or sanctioned by the Obama administration; in the twelve months since the election, 72 entities have been designated or sanctioned, representing a 61% drop. The administration also opposed HR 850, the *Nuclear Iran Prevention Act of 2013*, which passed by a vote of 400-20 on July 31, 2013 and threatened to veto S.1881, the *Nuclear Weapons Free Iran Act of 2013*, which has 60 cosponsors.[7] The U.S. government, however, still continues to impose significant fines on international financial institutions involved in Iran sanctions violations in order to constrain Iran's ability to access the global financial system.

- ***Direct Relief is Higher than White House Estimates and Indirect Benefits are Significant:*** A narrow accounting exercise would suggest that the JPOA gave Iran access to $4.2 billion in assets and increased export earnings by over $7 billion (energy, especially condensates, petrochemicals, and other related non-oil exports) in the last six months, for total direct relief of $11 billion, which is higher than the U.S. administration estimates of approximately $7 billion in total direct relief. However, such an accounting exercise fails to capture the indirect benefits to the Iranian economy, including improved market confidence; reduced transactions costs; and access to lower-cost, higher-quality imports which bolster industrial production, employment, and eventually economic growth. Meanwhile, tighter monetary policy and access to reserves have helped stabilize Iran's currency, which strengthens local and external purchasing power. The Obama administration has not adequately taken into account these indirect economic benefits in assessing the extent to which economic relief could enhance Iranian negotiating leverage.

- ***Increased Exports of Oil and Condensates Provide a Key Windfall for Iran:*** The greatest benefit to Iran stems from the suspension of requirements that countries significantly reduce their purchases of Iranian crude oil in order to qualify for exceptions to U.S. sanctions under the FY2012 National Defense Authorization Act (NDAA), the decision by the Obama administration to not include condensates as part of the significant reductions required by the NDAA, and the decision to block the passage of congressional legislation (HR 850 and S.1881), which would have mandated that condensates be included. This waiver of existing U.S. law on oil-related transactions boosted Iran's oil output even more than what was envisioned in the JPOA. Rather than holding steady at approximately 1 million bpd as envisioned by the JPOA, oil exports, including condensates, rose by about 400,000 barrels per day to 1.4 mbd, earning Iran approximately $5

5. Barack Obama, "Statement By The President On First Step Agreement On Iran's Nuclear Program," *The White House*, November 23, 2013. (http://www.whitehouse.gov/the-press-office/2013/11/23/statement-president-first-step-agreement-irans-nuclear-program)
6. U.S. Department of State, "Fact Sheet: Iran Freedom and Counter-Proliferation Act of 2012," accessed June 25, 2014. (http://www.state.gov/documents/organization/208111.pdf)
7. Paul Richter, "White House-Congress Divide on Iran Nuclear Sanctions Widens," *Los Angeles Times*, July 27, 2013; (http://articles.latimes.com/2013/jul/27/world/la-fg-us-iran-20130727) & "Final Vote Results For Roll Call 427," *Office of The Clerk U.S. House of Representatives Website*, July 31, 2013; (http://clerk.house.gov/evs/2013/roll427.xml) & John B. Judis, "The Boldest part of Obama's Speech Was His Iran Veto Threat," *New Republic*, January 28, 2014; (http://www.newrepublic.com/article/116390/three-cheers-obamas-veto-threat) & "Cosponsors: S.1881 – 113th Congress (2013-2014)," *Congress.gov Website*, accessed July 11, 2014. (https://beta.congress.gov/bill/113th-congress/senate-bill/1881/cosponsors?q=%7B%22search%22%3A%5B%22s1881%22%5D%7D)

billion in additional revenues over six months, on top of the approximately $2-3 billion earned by non-implementation of automatic cuts to maintain exceptions in the second half of 2013. We estimate that Iran remains reluctant to discount oil and condensates much. While most of Iran's oil revenues remain in escrow accounts (per the U.S.-led sanctions regime), the output growth is benefiting the broader economy. As such, the benefit from oil exports was even greater than we anticipated at the end of last year when we did our preliminary accounting of the likely impact of the JPOA.

- ***Condensate Loophole is Growing:*** Condensates have accounted for most of the increase in oil export volumes in the last six months, accounting for an estimated 300,000 barrels per day. We have included condensates in our estimates of oil export gains, although they were not included in the significant reduction mechanism, for two reasons: First, condensates are broadly fungible with other exports of petroleum liquids (e.g. Iran can use crude oil domestically and export condensates). Second, we believe that the improved international sentiment towards Iran has helped Iran to sell a larger volume of condensates. While these revenues from condensates are being restricted in escrow accounts, the easing of some financial sanctions and the development of rerouting mechanisms to facilitate payment has likely increased the willingness of Iran's buyers to buy more condensates.

- ***Iran's Economy is Returning to Growth:*** Helped by the reversal in sanctions momentum and improved market sentiment, Iran's economy began expanding on an annual basis in early 2014. After a sharp recession of -6.6% in fiscal year (FY) 2012/13, Iran's economy flat-lined by late FY 2013, paving the way to a modest expansion in 2014/15 (2% y/y), similar to IMF forecasts. Tight monetary and fiscal policies contributed to the stabilization and to some extent deferred the bounceback in economic growth. To be sure, recent statistical revisions and data limitations complicate the forecasting exercise, but Iran's economy is on an upward trajectory. If there had not been an improvement in market sentiment or sanctions relief, Iran would have remained in a deep recession.

- ***Impact of Sanctions Relief Will Build:*** Implementation hurdles delayed the benefits from the easing of import restrictions (e.g. for the auto sector) on domestic production and employment, mitigating the impact of sanctions relief. However, because the benefits have been delayed, Iran's economy is poised to experience greater benefits in the next six months even if no additional sanctions relief is built into a renewal of the JPOA. Any further concessions would further add to the economic expansion.

- ***Greater Economic Resilience Could Mean Greater Nuclear Intransigence:*** The gradual economic improvement, even at well below the current growth trends, provides breathing space for Iran's leadership to accumulate more reserves and savings via maintaining fiscal spending patterns, thus increasing resilience to withstand future sanctions. This reduces the leverage held by the P5+1 in current and future negotiations. So, while economic conditions may still feel very depressed to many Iranians due to tighter monetary policy and little government stimulus, these overarching trends could influence the calculus of Iran's leaders to become even more inflexible in negotiations over their nuclear program as the sanctions pressure on Iran's economy diminishes.

Dissecting the Sanctions Relief Package

The elements of sanctions relief can be divided into three areas: (1) suspended sanctions on oil transactions involving the Central Bank of Iran (CBI); (2) the suspension of related measures in other sectors (petrochemicals, auto, precious metals); and, (3) improved access to foreign assets. Collectively this relief facilitates more exports (oil and to a lesser extent petrochemicals), boosts imports (access to foreign assets, auto parts), reduces transactions costs (by reducing self-insurance), and increases industrial output and employment (oil and other key sectors). We classify the different elements of sanctions relief in Figure 1 including our assessment of the forecasted and actual impact.

However, White House estimates typically focus only on the access to foreign assets and on the potential increase in export revenues in key sectors, rather than considering the indirect effect of industrial production and job growth, which is arguably more important for Iran's economic activity and overall well-being.

The JPOA gave Iran access to $4.2 billion in assets and increased export earnings by about $7 billion in the last six months, for a conservative total of about $11 billion, which is greater than the Obama administration's estimates. As shown in Figure 1 below, the increase in oil and condensate exports increased revenues by around $5 billion in the six-month period, based on volumes available from a variety of international energy sources and Iran's customs administration. We assume Iran was able to attract global prices for its exports, assuming only a moderate discount to the current Iranian oil price of just under $100/barrel averaging by oil blend. Most of this increase in output came from volumes of condensates, which rose about 300,000 barrels per day based on Iran customs data.[8] Condensates are not subject to the significant reduction legislation and thus form a loophole for Iran's oil export volumes. These revenues from condensates, however, are subject to the accounts restrictions, which means that Iran can only spend these revenues on non-sanctionable goods in those countries that purchased the condensates (or on humanitarian goods from any country).

In addition to the oil revenue increase, we estimate that Iran's non-oil exports increased by $2 billion in the six-month period due to the removal of petrochemical sanctions and suspension of certain financial sanctions, which is starting to reduce transactions costs and increase the value Iran retains of both imports and exports by reducing costs paid to intermediaries. This includes modest increases in petrochemical, natural gas liquids and some manufactured goods for a total of $2 billion in non-oil exports. Moreover, the easing of financial sanctions implementation allows Iran to retain more of its export value because there is less need for discounting and payments to intermediaries. Iranian customs data suggest an increase in petrochemical exports, which accounted for about $12 billion in FY 2014. We estimate these have risen by about 10% in 2014 or about $1 billion.[9]

But the JPOA also contributed to a notable increase in imports in early 2014 – an indirect effect on the economy and contribution to economic growth and employment (see below), which is equally, if not more, important.

The auto sector is a case in point. At its peak, Iran's auto sector, which is based on assembly of cars produced abroad with minimal value added domestically, accounted for 10% of Iran's GDP, though it earned only a few billion dollars annually from exports. We don't expect a meaningful increase in exports, and indeed, the sector will boost demand for auto parts imports. However it will increase employment, increase industrial production, and provide access to locally produced goods rather than forcing Iran to purchase more expensive and highly-taxed imports.

To be sure, the impact of these measures on the domestic economy depends in part on the policy stance of the Iranian government. Iran's leaders must choose whether to spend or save increases in revenue, where to spend it (social transfers, infrastructure, recapitalizing the banks), and whether to maintain its tight monetary policy stance. Evidence suggests that the government will remain conservative and focus on building reserves and increasing the resilience of the economy to

8. Islamic Republic of Iran Customs statistics section (translated from the Farsi version) (http://www.irica.gov.ir/Portal/Home/Default.aspx?CategoryID=68bde3d2-c2d5-411f-a8b8-2b50ce202c04) and "Iran's cheap condensate export up 258% since nuclear deal" (http://en.trend.az/regions/iran/2260198.html)
9. "Statistics Section," *The Islamic Republic of Iran Customs Administration (IRICA)*, (translated from Farsi), accessed July 12, 2014. (http://www.irica.gov.ir/Portal/Home/Default.aspx?CategoryID=68bde3d2-c2d5-411f-a8b8-2b50ce202c04)

insulate it from future shocks. Continued fiscal restraint would, of course, diminish Iranian economic growth over the medium term, but it would shore up the government's ability to withstand an escalation in sanctions pressure in the future.

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Figure 1: Expected versus Actual Impact of the JPOA

Elements of JPOA	Type of Measure	Expected Impact	Impact
Oil exports waiver relaxation on transactions	Suspended sanctions	Cap oil exports at mid-2013 level (1m b/d) rather than mandated declines.	Slightly greater than expected. Oil exports rose by 100K b/d from October 2013 levels rather than declining (see condensate section).
Insurance/Financial services	Suspended sanctions	Moderate reduction of transactions cost. Limited due to banking sector issues in Iran, implementation uncertainties.	As expected. Relaxation may also have amplified the effect of rising condensate exports.
Petrochemical exports	Suspended sanctions	Modest increase in exports ($1 billion).	As expected. Confirmed by Iranian customs data.
Access to $4.2bn in oil revenues	Access to assets	Facilitate imports from preferred trade partners and diversify imports.	Lagged effect due to logistical hurdles, uncertainty among foreign banks/bureaucratic issues in Iran.
Auto trade	Suspension of sanctions	Increase in output, parts imports, and domestic output.	As expected, production levels increased. Impact already began per JPOA with output increasing.
Precious metals trade	Access to gold as means of exchange for trade.	Moderate increase in gold imports as a way of repatriating profits. Tighter monetary policy restrains demand.	As expected. Little evidence of increased gold trade due to self-sanction by foreign partners (Turkey).
Increased exports of condensates	Indirect	The condensates loophole was not expected to be a major channel for sanctions relief, so we assume that condensates production was intended to be stable.	Condensates drove oil export increase, rising by about 400K b/d since November ($4-5 billion in 6 months). Increase in condensates exports was aided by improved sentiment and financial conditions (other elements of sanctions relief).
Multiplier effect on non-oil trade	Indirect	Increase trade due to lower transaction costs.	As expected. Imports have risen, and non-oil exports have shown a moderate increase (approx $2 billion): $1 billion in petrochemicals plus $1 billion in increases in manufactured outputs and higher value for existing exports from suspension of some financial measures which reduce transactions costs.
Improved sentiment/investment	Indirect	Global sentiment toward Iran to improve, but investment requires lifting of sanctions.	As expected, effect predates JPOA. Sentiment has been on an improving but volatile track. No evidence of new investment yet.

Assessing Iran's Economy

It is by now evident that the Iranian economy has shown signs of stabilization since Rouhani's election in June 2013. Recent data released by the Iranian government supports the view that the economy bottomed out in mid-

2013.[10] Indeed, Iran has been on a modest recovery path since its *annus horribilis* of 2012 and the first half of 2013, when the economy was hit with an asymmetric shock from sanctions targeting the CBI and Iranian oil exports; the barring of Iranian banks from the SWIFT international banking system; and strictures on the National Iranian Oil Company (NIOC), shipping and insurance, key sectors of the Iranian economy, and precious metals, among others. The poor economic management of the Iranian economy by the Mahmoud Ahmadinejad government further exacerbated these sanctions-induced shocks as it reduced the economy's resilience to these shocks.

With the election of Rouhani, sanctions pressure began to de-escalate for several reasons. Since July 1, 2013 when the *Iran Freedom and Counter-Proliferation Act of 2012* came into effect, no new sanctions have been imposed, and there has been a significant reduction in Iranian entities designated by the United States.[11] In the twelve months before the election of Rouhani, 183 entities were designated or sanctioned by the Obama administration; in the twelve months since the election, 72 entities have been designated or sanctioned, representing a 61% drop. The administration also opposed HR 850, the *Nuclear Iran Prevention Act of 2013*, which passed by a vote of 400-20 on July 31, 2013 and threatened to veto S.1881, the *Nuclear Weapons Free Iran Act of 2013*, which has 60 cosponsors.[12] The U.S. government, however, still continues to impose significant fines on international financial institutions involved in Iran sanctions violations in order to constrain Iran's ability to access the global financial system.

Sanctions relief gave Iran access to more of its previously locked-up foreign exchange reserves as well as certain key imports, such as auto parts, which supported industrial activity. The Rouhani government will continue to capitalize on the de-escalation of sanctions, which would have otherwise hit revenues, prompting renewed weakness in the exchange rate, exacerbating inflation, and even creating asset spirals. The government is expected to focus on structural changes and shoring up economic fragilities in the absence of harsher sanctions.

Even still, tighter fiscal and monetary policy, including spending caps and an increase in fuel costs, as well as the absence of real credit growth, has limited Iran's economic growth trajectory. Without the JPOA and the resulting increase in oil revenues, the fiscal cuts would have been much more extensive and the recession much deeper. Instead, recent data released by the CBI reveals public consumption is recovering, posting positive annual growth for fiscal year 2013.

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Looking forward, IMF estimates, trade data, and a new Iran sentiment indicator, developed by Roubini Global Economics and using proprietary technology and data from Ravenpack, all suggest that Iran's economy is likely to post positive full-year growth in fiscal year 2014, as consumption continues on a positive track and investment stabilizes amidst improving government revenues, stronger confidence, and a lessening drag from inventory adjustments.

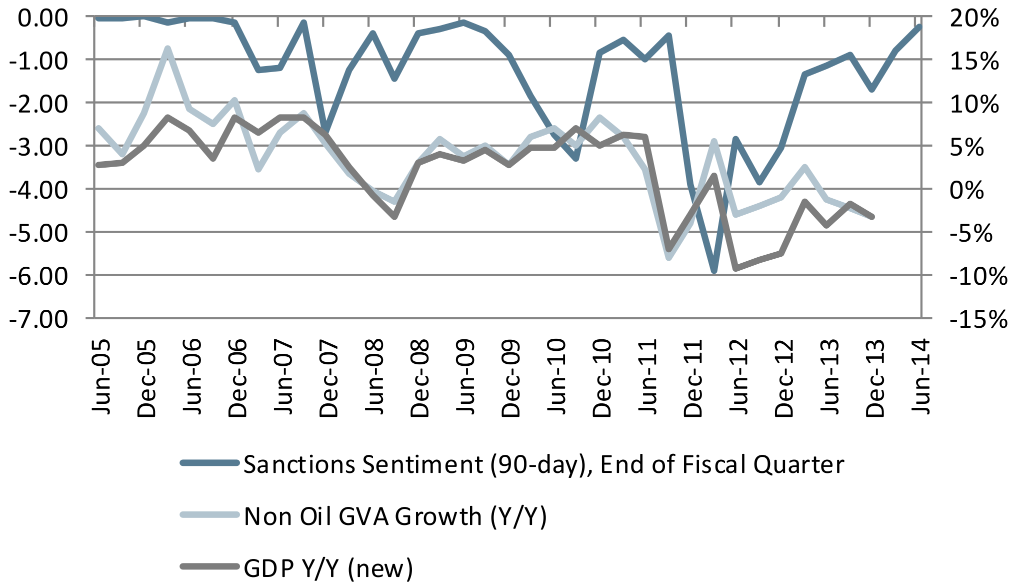
10. Central Bank of the Islamic Republic of Iran, "Economic Trends No 74, Third Quarter 1392 (2013/2014)," June 2014. (http://www.cbi.ir/page/11933.aspx)

11. U.S. Department of State, Press Release, "Fact Sheet: Iran Freedom and Counter-Proliferation Act of 2012," July 1, 2013. (http://www.state.gov/documents/organization/208111.pdf)

12. Paul Richter, "White House-Congress Divide on Iran Nuclear Sanctions Widens," *Los Angeles Times*, July 27, 2013; (http://articles.latimes.com/2013/jul/27/world/la-fg-us-iran-20130727) & "Final Vote Results For Roll Call 427," *Office of The Clerk U.S. House of Representatives Website*, July 31, 2013; (http://clerk.house.gov/evs/2013/roll427.xml) & John B. Judis, "The Boldest Part of Obama's Speech Was His Iran Veto Threat," *New Republic*, January 28, 2014; (http://www.newrepublic.com/article/116390/three-cheers-obamas-veto-threat) & "Cosponsors: S.1881 – 113th Congress (2013-2014)," *Congress.gov Website*, accessed July 11, 2014. (https://beta.congress.gov/bill/113th-congress/senate-bill/1881/cosponsors?q=%7B%22search%22%3A%5B%22s1881%22%5D%7D)

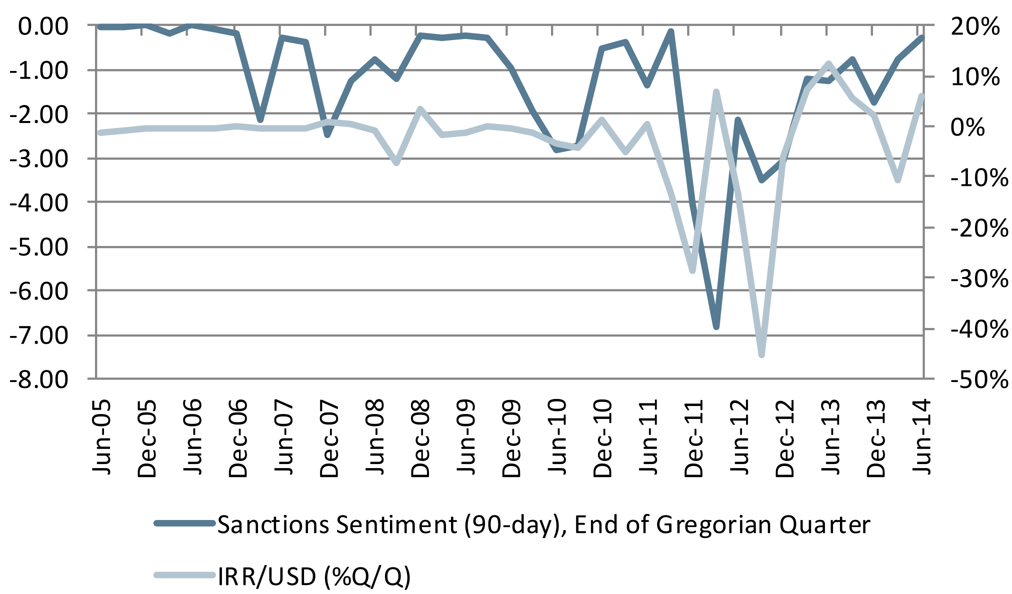
As shown in Figures 2 and 3, the sentiment indicator leads improvements in macroeconomic performance and coincides with improvements in Iranian assets as described in more detail in a previous publication. [13]

Figure 2: The Improvement in Sentiment Leads to Improvement in Economic Performance



Source: Ravenpack, Haver Analytics, RGE

Figure 3: The Improvement in Economic Sentiment Coincided With Strengthening of the Rial

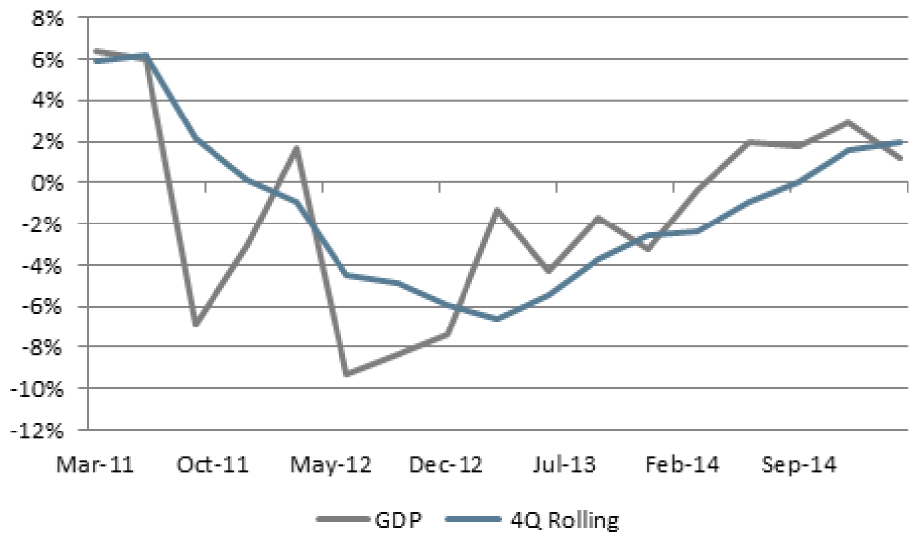


Source: Ravenpack, Haver, RGE

13. Paul Domjan and Mark Dubowitz, "New Sentiment Indicator Shows Positive Impact of Sanctions Relief on Iran's Economy," *FDD Iran Sanctions Analysis*, May 15, 2014. (http://defenddemocracy.org/media-hit/dubowitz-mark-new-sentiment-indicator-shows-positive-impact-of-sanctions-relief-on-irans/)

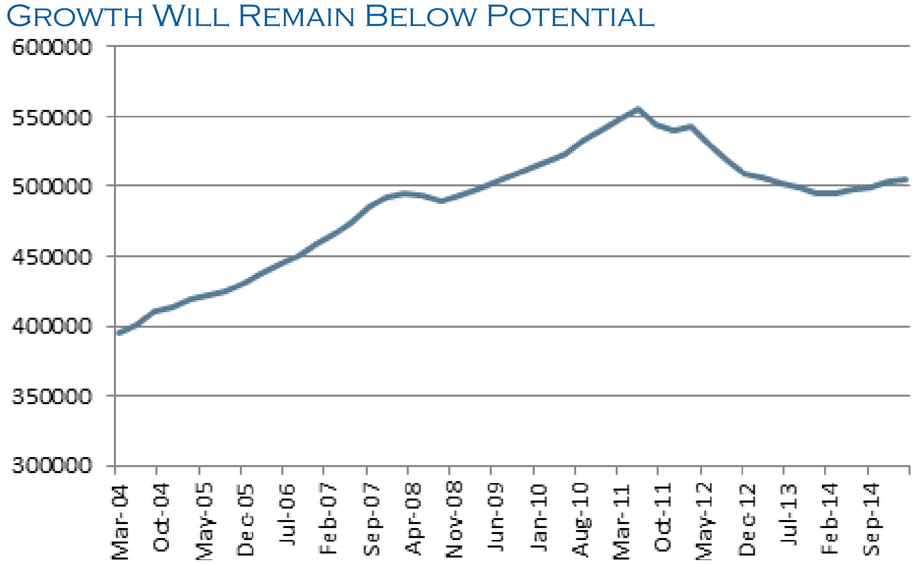
After a sharp recession of -6.6% in fiscal year (FY) 2012/13, the economy effectively flat-lined by late 2013, resulting in negative growth of 2-2.5% in FY 2013/14 (Figures 4 and 5). Although some of Iran's economic recovery reflects a mechanical bounce from extreme contraction, the forthcoming expansion of the oil and gas sector (Figure 6) and industrial production will favorably impact overall growth as a result of rising investment and employment. So far, in 2014, oil exports have already climbed by over 300,000 barrels per day – particularly to China and India as they have increased condensate imports. Meanwhile, a drop in inflation has benefited Iranian purchasing power domestically. This bodes well for consumption, particularly if sanctions relief continues. At the current rate, the economy will expand by roughly 2% in FY 2014/15. Risks are skewed towards a greater expansion as oil output increases, and domestic confidence and investment follows.

Figure 4: Iran's Economy Likely Returned to Positive Growth on an Annual Basis (y/y% growth, actual and forecast).



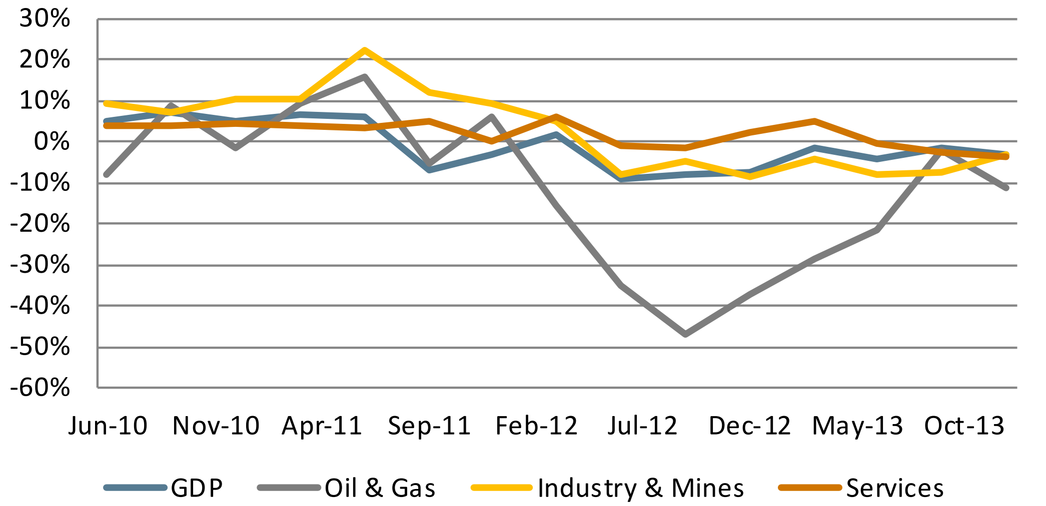
Source: CBI, Roubini Global Economics

Figure 5: Real Growth Will Remain Below Potential



Source: CBI, Roubini Global Economics

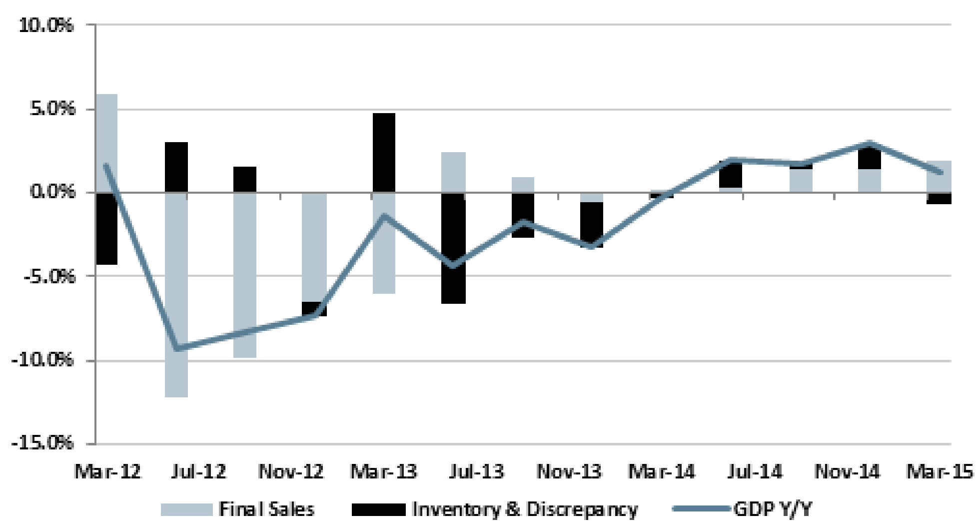
Figure 6: Oil Sector drag largely vanishes in 2013 (% y/y)



Source: Central Bank of Iran, RGE

Iran's oil production began to expand in early 2014, offsetting weakness in other sectors suffering from a lack of capital from local and foreign investors and tight fiscal policy. Figure 7 shows the projected path of recovery and highlights that final demand (GDP excluding changes in inventories and discrepancies) already expanded by 0.9% Y/Y in the first three quarters of FY 2013/14 (vs -3.1% for the headline). We expect that the oil, gas, and mining sectors will be positive contributors to growth in 2014. These improvements will offset weaker growth in more domestic demand-driven industries including the service sector, which remains subdued on weak credit and a lagging labor market. It is also likely that, despite historic mismanagement, Iranian oil output can be maintained at around 2.8 million barrels per day, with exports at around 1.4 million barrels per day by mid-2014 and rising toward 1.6 million bpd later this year.

Figure 7: Final Demand is Already Positive (contribution to GDP growth, % Y/Y)



Source: Central Bank of Iran, RGE

What would bring stronger growth? More extensive government consumption or transfers could pump up the Iranian economy. Similarly, a boost could come from capital inflows that facilitate investment and employment. At this point, global companies are still reticent to invest in Iran, as sanctions are only suspended – rather than legally removed. As a result, obstacles remain on transferring funds, and risk managers worry that suspensions could be reversed. Should sanctions unwind more quickly as a result of provisions contained in a comprehensive Iran nuclear agreement, or should Iran receive additional sanctions relief in exchange for the renewal of the JPOA for a further six-month term, oil output and revenues could rise more dramatically and additional waivers on sector-based sanctions could encourage investment.

> ***"At this point, global companies are still reticent to invest in Iran, as sanctions are only suspended – rather than legally removed... Should Iran receive additional sanctions relief in exchange for the renewal of the JPOA for a further six-month term, oil output and revenues could rise more dramatically and additional waivers on sectoral sanctions could encourage investment."***

Access to Revenues is Increasing

Iran's crude oil revenues continue to be captured in escrow accounts, per the sanctions regime. The regulations require that these oil revenues be used for humanitarian trade or for non-sanctionable trade with Iran's main oil buyers – China, India, Japan, South Korea, and Turkey. As highlighted in Figure 8, Iran's surpluses in Turkey, Japan, and China are extensive, accounting for $4-6 billion in 2013 alone. Condensates are not covered by U.S. measures to significantly reduce oil imports from Iran although revenues are captured in escrow accounts. They therefore cannot be used to gain access to more foreign assets to add to accessible reserves, which we have previously noted are very low. However, even if condensate revenues collect in escrow accounts, Iran benefits from increased output. To the extent that these condensate exports are difficult to track, gaps in compliance also could allow for additional revenues to flow directly to the regime, boosting resilience and potentially feeding through to growth.

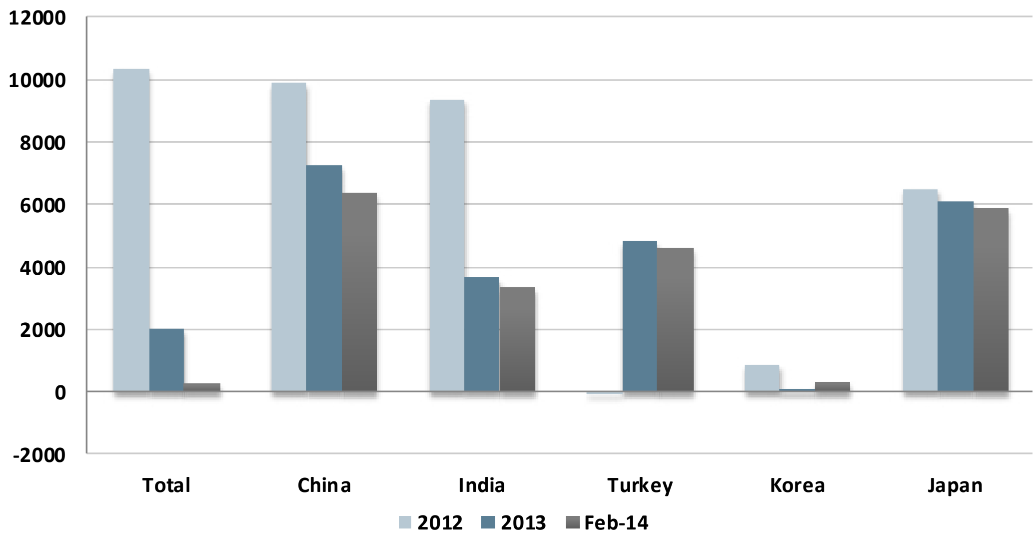
> ***"Even for these crude oil and condensate revenues, however, sanctions are not water tight... A recently leaked Turkish prosecutor's report aimed at exposing corruption in Recep Tayyip Erdogan's AKP government, demonstrates the potential for significant leakage and sanctions busting."***

Even for these crude oil and condensate revenues, however, sanctions are not water tight. A recently leaked Turkish prosecutor's report aimed at exposing corruption in Recep Tayyip Erdogan's AKP government, demonstrates the potential for significant leakage and sanctions busting.[14] The report alleges that Iranian banks used SWIFT for illicit financial transactions involving "gas-for-gold" and fraudulent humanitarian schemes. According to the report, Pasargad Bank, Parsiaan Bank, Sarmaye Bank, Bank Tos-e-Sadarat, Karafarin Bank, and Saman Bank processed transactions for the network of Iranian businessman Reza Zarrab, who is accused of having processed more than €87 billion in illicit transactions between 2012 and 2013.[15] This amount is equal to Iran's total foreign exchange reserves, and is five times greater than previous estimates of Iran's fully accessible cash reserves.[16] Even if

14. Istanbul Cumhuriyet Bassavciligi, "Sorusturma No: Istanbul CBS 2012/120653," December 18, 2013. (http://www.cumhuriyet.com.tr/haber/turkiye/50525/Fezlekeleri_indirmek_icin_tiklayin.html)
15. "87 Billion Euros In Suspicious Transfers From Iran," *Today's Zaman* (Turkey), December 17, 2013. (http://www.todayszaman.com/news-334277-87-billion-euros-in-suspicious-transfers-from-iran.html)
16. Mark Dubowitz & Rachel Ziemba, "When Will Iran Run Out Money?," *Roubini Global Economics & Foundation for Defense*

this number is significantly overstated, the transfer of $13 billion in gold to Iran during 2012-13 as part of the "gas-for-gold" scheme, which underpinned the broader Zarrab money laundering structure, involved a large infusion of hard currency at a time when Iran was struggling to access its overseas assets. Although this loophole has since been closed, and Iran is again facing significant financial restrictions in Turkey, it suggests that other loopholes may have opened elsewhere, including through falsified humanitarian transactions, which also appear to have been part of the Zarrab scheme.

Figure 8: Iran is Building up Surpluses with Key Trading Partners (annual bilateral trade surplus, $ million)



Source: IMF, RGE

Easing Inflation Increases Iranian Purchasing Power

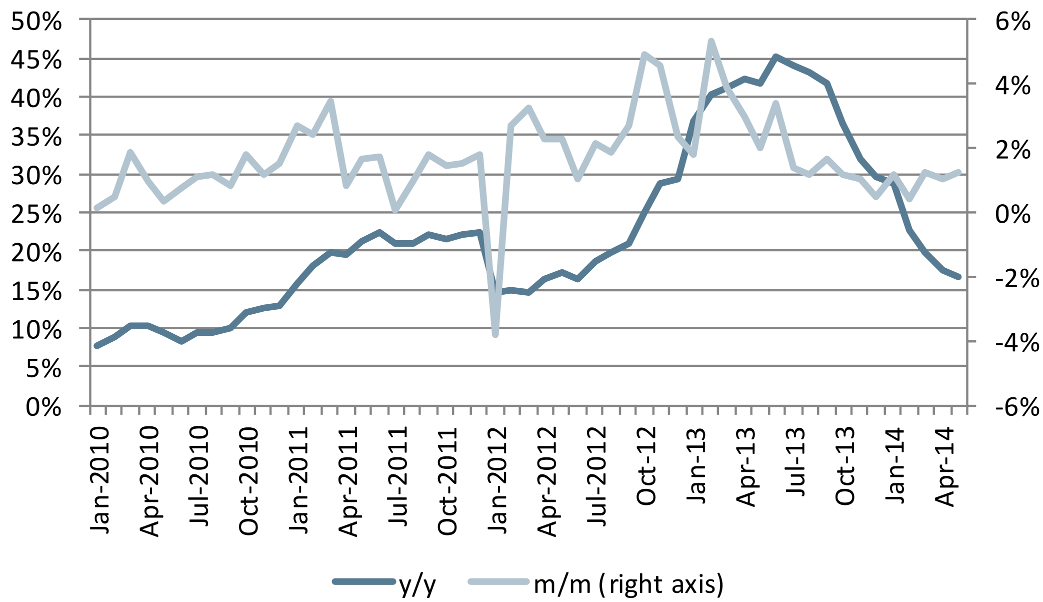
> ***"Inflation is perhaps the greatest area of macro policy improvement for Iran, reflecting the improved sentiment thanks to an environment of de-escalating sanctions pressure and better policy decisions of the Rouhani government compared to its predecessor."***

Inflation is perhaps the greatest area of macro policy improvement for Iran, reflecting the improved sentiment thanks to an environment of de-escalating sanctions pressure and better policy decisions of the Rouhani government compared to its predecessor. This has contributed to the stabilization and appreciation of the rial. The easing of inflation has increased the purchasing power of Iranian households and helped reduce hoarding behavior. After peaking at around 45% year-over-year in early 2013, annual inflation eased below 20% year-over-year in Q1 2014 (Figure 9). It stabilized in Q2 2014, as first housing and then food prices softened. The recently implemented fuel price hike does add a bit of price pressure in the short-term, but the current policy mix suggests that inflation will remain anchored below 20% and be less volatile, allowing consumers and

of Democracies, October 2, 2013; (http://www.defenddemocracy.org/stuff/uploads/documents/Iran_Report_Final_2.pdf) & Foundation for Defense of Democracies, Press Release, "New Report on the Impact of Sanctions on Iran's Foreign Exchange Reserves," October 2, 2013. (http://www.defenddemocracy.org/media-hit/new-report-on-the-impact-of-sanctions-on-irans-foreign-exchange-reserves/)

companies to better plan for the future. Iran's policy mix likely can cope with these shocks. Indeed, fiscal and monetary policy is tighter, the rial has already weakened, and wages have remained subdued in real terms due to high unemployment.

Figure 9: Inflation Has Bottomed Out (%)



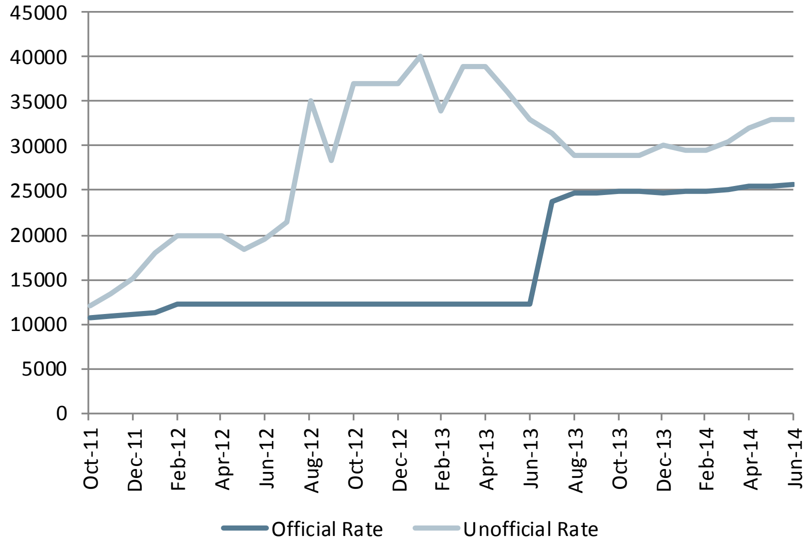
Source: Central Bank of Iran (Haver Analytics)

Increasing Oil Output Will Support Iran's Currency

The strength of the rial has boosted the purchasing power of Iranian consumers. The Iranian rial has weakened slightly in the black market after a period of particular strength following Rouhani's election. The rial's slide toward 33,000 to the dollar since March 2014 coincides with a widening of the gap between the official and unofficial exchange rates from 15% to 20% (Figure 10). In the IMF's view, at early 2014 oil export levels (1 to 1.2 million bpd), the rial remains slightly overvalued and at risk of modest depreciation. Given that oil exports have increased above that level and Iran has gained access to some of its overseas assets, the rial looks better supported. A major shock, like a 250,000-500,000 barrel per day drop in oil exports from current levels, would be required for a major depreciation that hits purchasing power. The continuation of current trends suggests that an increase in oil output and greater access to reserves should keep the rial stable and possibly even allow for mild appreciation, particularly as the Central Bank maintains its tight policy of higher interest rates. This policy trend increases Iranian purchasing power domestically and abroad, assuming that Iranians can continue to access some of their overseas accounts.

"The strength of the rial has boosted the purchasing power of Iranian consumers."

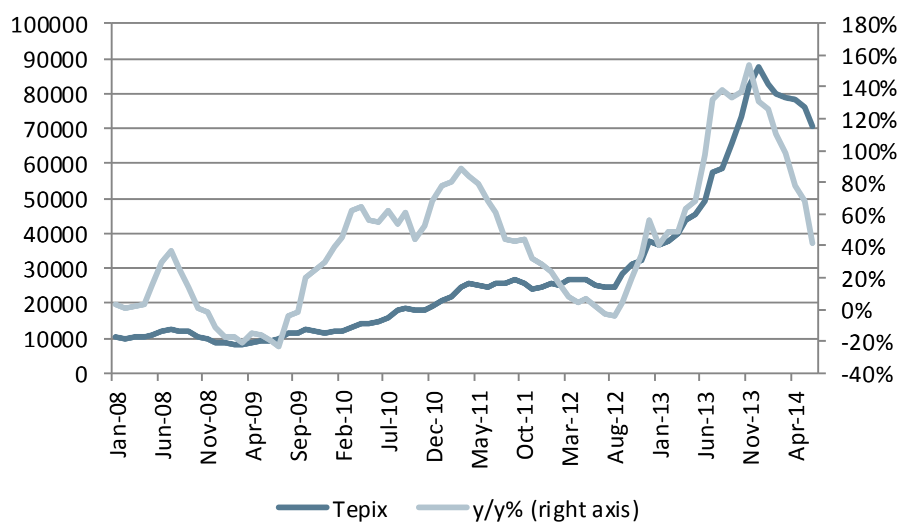
Figure 10: Slight Depreciation Pressure on the Rial (vs USD)



Source: Haver Analytics, Eranico

A major benefit for Iran of more stable inflation and currency expectations comes from the reduction in asset inflation and bubbles. High inflation fuels asset bubbles as local actors search for stores of value, exacerbating price pressures. While consistent data on housing prices is hard to come by, the housing price component of the Consumer Price Index (CPI) gives one indication about the easing of housing prices. The reduction in inflation and improvement in the macro environment reduced the need for Iranians to store wealth in domestic assets, which would be likely to hold their value (gold, equity, property). Figure 11 suggests that stabilizing inflation has helped temper the equity boom. Sanctions relief can have several positive effects to offset asset bubbles. For example, lower inflation reduces nominal price appreciation. Access to foreign assets and means of exchange reduces the need to store wealth domestically and eventually encourages spending. Eventually, Iranians might be able to diversify their portfolios abroad. So far, in Iran, the first two have materialized, though the latter has yet to come to pass.

Figure 11: Lower Inflation is Tempering Equity Boom



Source: Haver Analytics

Conclusion: Impact of a JPOA Extension, What Would Happen If Current Trends Continue?

The de-escalation of sanctions since mid-2013 and the suspension of some sanctions through the first half of 2014 as a result of the JPOA generated extensive positive economic effects. Foreign businesses in sectors not subject to sanctions are cautiously beginning to take advantage of the relief offered in the JPOA, facilitating slow but increasing imports of foreign inputs (e.g. for the auto sector). This has translated into increased domestic production and employment. If the JPOA were extended, the benefits to the Iranian economy would be substantially greater in the second six months than in the first six months of the JPOA – even if the terms of sanctions relief remain unchanged.

> ***"If the JPOA were extended, the benefits to the Iranian economy would be substantially greater in the second six months than in the first six months of the JPOA – even if the terms of sanctions relief remain unchanged."***

Many elements of the sanctions relief package, including the suspension of certain financial sanctions and sector trade restrictions, only recently came into effect. For example, reduced transactions costs could remove the need for discounting, increasing revenues to Iranian entities. A JPOA extension could facilitate a further increase in oil exports (including condensates). A conservative estimate suggests that production increases could yield some 3 million barrels per day and a rise in exports to over 1.6 million bpd, up 200,000 barrels per day from current levels. At current export prices of around $95-100 per barrel, this would increase oil revenues alone by a further $3.6 billion in the next six months. Coupled with increased access to assets in escrow accounts abroad, this would substantially increase Iran's accessible foreign asset holdings, strengthen its reserve position, and allow more imports. These reserves could then be used either to build up immunity against further sanctions or strengthen the domestic economy.

> ***"Even though the Iranian economy cannot fully recover while the toughest sanctions remain and investment is scarce, the sanctions relief package could facilitate further economic expansion and decrease the pressure on Tehran... The reversal of the steep sanctions-induced recession that prompted an economic free fall in 2012-2013, and the benefits accrued to Iran as a result of the JPOA in 2014, have enhanced Iranian nuclear negotiating leverage."***

Suspended sector-based sanctions (auto sector and petrochemicals) are likely to increase exports moderately but have a more meaningful effect on non-oil domestic production and employment, thereby supporting domestic income and economic output.

To be clear, an extension of the interim deal would not necessarily increase the willingness of foreign investors to make direct investments in Iran, as these are longer-term in nature and require more clarity on the regulatory environment. Even though the Iranian economy cannot fully recover while the toughest sanctions remain and investment is scarce, the sanctions relief package could facilitate further economic expansion and decrease the pressure on Tehran. Iran is already benefiting from a change in the sanctions environment: While painful financial and energy sanctions played a major role in persuading Iran to engage in more serious negotiations with the P5+1 over its nuclear program, the reversal of the steep sanctions-induced recession that prompted an economic free fall in 2012-2013, and the benefits accrued to Iran as a result of the JPOA in 2014, have enhanced Iranian nuclear negotiating leverage. This likely makes it more difficult to conclude a diplomatic deal that dismantles Iran's military-nuclear and ballistic missile programs.

The Foundation for Defense of Democracies (FDD) is a non-profit, non-partisan 501(c)3 policy institute focusing on foreign policy and national security. Founded in 2001, FDD combines policy research, democracy and counterterrorism education, strategic communications and investigative journalism in support of its mission to promote pluralism, defend democratic values and fight the ideologies that drive terrorism.

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