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The Economic Impact of International Sanctions on Iran

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The Institute for Policy and Strategy

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Executive Summary

The accumulating effect of the sanctions has already started to bite into the fabric of the Iranian economy.

Sanctions are hurting Iran's efforts to increase its oil production, and indeed expected to cause production and export reduction; and have reduced foreign investment, particularly in the oil & gas sector. International companies are increasingly reluctant to do business with Iran, considering the high risk associated with such business; Iran is already cut off from most of the international banking system, and faces severe difficulties in the fields of insurance, transportation, and external trade.

However, though the direction and intensity of the process are clear and powerful, the cumulative effect, to date, is not yet strong enough to force the Iranian regime to re-think its policies on the nuclear issue. Furthermore, one should always take into consideration that the Iranian regime can fight back; for example by taking moves which would threaten or even mildly interfere with the flow of oil and gas from the Persian Gulf; or otherwise putting pressure on oil and gas production, shipping or other economic activities in the Persian Gulf area.

Looking ahead for the coming months, one should look mainly for the impact of the sanctions on internal economic affairs, and especially the following issues:

- The continuation and aftermath of subsidy reductions, which are expected to be probably the hottest political issue in Iran; coupled with mounting difficulties in balancing the state budget.
- Indications for other effects on the standard of living of low-income classes, unemployment rates, etc.
- Shortage in various important consumption and industrial items: primarily oil products, but also critical imported products for industrial production, etc.
- Mounting pressure on the banking system, which may reflect on the stability of Iranian banks
- Difficulties in oil production and exports

The Four-Circle Structure of Intenational Sanctions on Iran

The complex structure of international economic sanctions on Iran, which has developed since the adoption of UN Security Council Resolution 1929 on June 9th 2010, can be described as composed of four concentric circles:[1]

- **The first, central circle:** the UN Security Council Resolution, which imposes basic set of sanctions, and has been the basis and the source of international legitimacy for the whole structure of international sanctions

1 Resolution 1929 was the fourth in row, following previous UN Security Council resolutions—1737, 1747, and 1803 of 2006 – 2008. See detailed discussion of these previous resolutions in the authors' working paper for the Herzliya Conference 2010 "The Economic Impact of Stricter US AND UN Sanctions on the Iranian Revolutionary Guard Corps

- **The second circle:** US and EU unilateral sanctions, which extend far beyond the UN sanctions, affect all major fields of the Iranian economy; and pressure other governments to join in implementing the UN sanctions, and add their own unilateral sanctions. Moreover, the US and EU sanctions focus on limiting international trade, investments, and financial transactions with Iran to a degree that forces international banks, insurers and other businesses to "mark" doing business with Iran as too risky for their much more important businesses in the US and the EU markets.
- **The third Circle:** application of the UN sanctions and observance of US and EU sanctions, by many other countries, including most important trade partners of Iran: the United Arab Emirates, Japan, South Korea, and others.
- **The fourth Circle:** the business sector – banks, insurance companies, and other businesses which trade with Iran, deal with Iranian banks, invest in Iran's oil sector, etc.

The wide range and complexity of US and EU sanctions on the one hand, and the great number of "banned" Iranian companies and entities on the other hand, has created a situation which makes any deal with an Iranian governmental or business entity too risky for international companies.

Application of the International Sanctions on Iran

The US and EU sanction packages are far-reaching, targeting Iran's energy industry as well as its transport, banking and insurance sectors. Under the new EU sanction regime, for example, European firms are not allowed to sell equipment to Iran for use in oil and gas exploration, refining and the production of liquified gas. European banks are not allowed to establish new "banking relations" with Iranian financial institutions, and "enhanced vigilance" is imposed on Iranian banks operating in Europe. Cash transfers of €10,000 and above require notification of domestic authorities and transfers of €40,000 and above require prior authorization. Insurance contracts for more than two years are to end, and those under two years are discouraged. Insurance and re-insurance companies are no longer allowed to offer their services to Iranian government bodies. Trade supports, including export credit guarantees, are forbidden.

The EU measures match the US level of restrictions. Moreover, the special importance of the EU sanctions lies in its position as the primary supplier of high-level technology to Iran. The US does not really do any significant business with Iran; and though Iran can get low-level technologies from China, Chinese technology is much less effective than European technology for developing their oil and gas sectors.

Japan and South Korea, and other leading economies like Australia and Canada, followed the US and the EU with their own packages of unilateral economic measures.

Even more importantly, the reaction of the international business community to the sanctions has been strong and rapid. All major international banks and many smaller ones have already stopped doing business with the Iranian banking system; international insurance and reinsurance companies are reluctant to provide coverage for Iranian ships and shipments; and the number of major international companies in other fields (e.g. oil, industry), which have decided to severe or significantly limit their business relations with Iran, is rapidly increasing. This includes multi-national giants involved in multi-billion projects or trade in Iran, such as Toyota, Kia, Lukoil, Allianz, Royal Dutch Shell, Total, Repsol, BP, Eni, and many more.

The Impact of Sanctions on the Iranian Economy

The Intensity, scope and speed of the 2010 round of sanctions have already put significant pressure on Iran's banking, insurance, transportation sector, and on its international trade; and, towards the end of 2010, the cumulative effect on the internal economic situation starts to show as well.

Iran's vulnerability to economic sanctions

Though Iran is a major oil exporter, the Iranian government is relatively vulnerable to well-targeted economic sanctions. Oil and gas exports that are Iran's main export revenues constitute about 80% of the total exports, the government's chief source of foreign exchange, and the most important source of revenue in the State Budget. The government's dependency on oil income makes it vulnerable even to partial decline in oil exports.

Iran's economy is dominated by the state, which is the recipient of revenues from crude oil exports, and in recent years by quasi-state actors, mainly the Islamic Revolutionary Guard Corps. This is the most powerful quasi-state actor, and its role in the economy has become even more dominant since the June 2009 Presidential Elections, along with its pivotal new position in Iranian politics. The Revolutionary Guard controls strategic industries and commercial services ranging from dam and pipeline construction to automobile manufacturing, along with illicit smuggling and black market enterprises; and its influence has been extended into virtually every sector of the Iranian market.

The Iranian petroleum sector is plagued with aging infrastructure and old technology. Iran needs large international investments in order to maintain its present oil production and export, and to develop its refining capacity.

The impact of sanctions on the banking sector

US Treasury regulations prohibiting US or foreign financial institution to deal with Iranian banks, has been extended, during the second half of 2010, to include all Iran's major banks. As a result of this move, the choice for international banks has become very clear: conduct business with those Iranian banks, practically Iran's whole banking system and loose access to US financial systems, or stop dealing with Iranian banks altogether.

All major international banks and many smaller ones have stopped providing financial services to Iranian banks. Iran is already cut off from most of the international banking system, and increasingly unable to conduct trade transactions in dollar and euro.

This, in turn, is expected to reflect on the stability of Iran's banking sector.

The IMF has already warned the Iranian government that bank soundness indicators have deteriorated. Iranian banks are facing increased credit risks and a significant increase in nonperforming assets, which at a certain point may jeopardize public confidence.

Insurance

A most important immediate result of US and EU sanctions has been the reluctance of insurance and reinsurance companies to provide coverage for Iranian ships and Iranian shipments.

Shipping

Insurance problems are gradually crippling Iran's shipping, including its ability to deliver oil via its large tanker fleet. In fact, the whole of Iran's large fleet of tankers is in danger of losing its insurance coverage, making it impossible to operate in international ports.

Among the hardest hit is Iran's governmental shipping company IRISL. This company is banned and the US Treasury is continuously slapping sanctions on shipping companies accused of operating as fronts for IRISL. In mid-January 2011, for example, the US banned 24 international shipping companies, for allegedly operating as fronts for IRISL. IRISL is already under tremendous financial pressure and is going to extreme lengths to obscure its network and the ownership of vessels. According to a US Treasury report, this company has recently defaulted on more than half a billion dollars in loans.

International trade

The complexity and wide scope of the sanctions of the US, the EU and other countries (which prohibit business relations with hundreds of Iranian companies, with tens of new companies added from time to time to the list of prohibited companies) has caused uncertainties for international companies about which Iranian entity is legitimate and which is illicit and subject to sanctions.

For trading companies and other businesses making such distinction on daily basis for their transactions is costly and risky. More and more companies find it easier and safer for them to cut their dealings with Iran altogether, than being subjected to US sanctions, penalties, and loss of access to the American market.

The intense and speedy impact of the sanctions on international trade with Iran's is felt quite dramatically in the United Arab Emirates (UAE).

The UAE is one of the most important trading partners of Iran, and substantial part of Iran's imports came through the huge free-trade zones of Dubai and other UAE free-trade zones.

The application of US sanctions in the UAE has dramatically affected its trade with Iran. The UAE authorities as well as banks, insurers, and transportation companies have applies more and more daily restrictions to thousands of Iranian traders and businesses, which are based in Dubai and deal with Iranian trade. Trade licenses that have an Iranian name on them trigger concern at banks, Iranian businesses are not allowed transfer money in Euros or dollars to Iran, shipments to Iran are carefully checked and face various difficulties.

Another indication comes from South Korea. A survey of South Korean companies, which was conducted among small and mid-size exporters to Iran, found that more than three-quarters of South Korea's small and mid-size exporters have partly or totally discontinued shipments to Iran following Seoul's sanctions. The cut-off was due mainly to fears they would be unable to receive payments for shipments.

The Impact on oil and gas production (and exports)

International pressure on Iran under previous UN resolutions (UN Security Council resolutions—1737, 1747, and 1803 of 2006 – 2008) had increased the hesitation of many major foreign firms to invest in Iran's energy sector, and hindered Iran's efforts to expand oil production.

The impact of the 2010 sanctions on Iran's oil sector will take more time to be felt. However, the exodus of major oil companies from Iran may reflect quite significantly on the level of oil production in the medium term. The rapidly aging oil industry of Iran is in need for huge investments (estimated at many tens of US dollar billions in oil infrastructure to maintain its current production level).

According to report submitted to the US Congress, Iran's oil production has already fallen slightly to about 3.9 million barrels per day, from over 4.1 million barrels per day several years ago, and sales to Iran of gasoline have fallen dramatically.

Less oil produced due to lack of new investments and maintenance, less oil revenues are generated. This will gradually lower oil exports without directly adding it to the embargo list.

Moreover, the pure economic risk of being dependent on oil imports from Iran has already pushed countries like China and Japan to lower their dependence on imports of oil from Iran, regardless of the international sanctions.

According to Chinese customs data released in September 2010, China has significantly reduced its oil purchases from Iran during 2010, both in terms of total volume and market share. According to the Chinese General Administration of Customs, from January through August, Chinese oil imports from Iran decreased by 25 percent compared to the same period of the previous year. Among China's top 14 suppliers in 2010, Iran is the only one with reduced oil sales compared to the first eight months of 2009. While Chinese oil imports from Iran have decreased nearly 25 percent, its total oil imports have increased by around 23 percent compared to the first eight months of 2009.

The most important project in the oil & gas sector already hit by sanctions is the South Pars gas field. South Pars is the Iranian portion of the world's largest gas field (the other portion is Qatari). Threatened by tougher US penalties, Western firms such as Shell, Total and Halliburton have already pulled out of the development of the South Pars gas field. Qatar that shares the gas field with Iran, exported $62 billion of mainly gas products in 2008, while Iran's gas exports brought in only about $6 billion.

Another important development relates to the Revolutionary Guard Corps' involvement in oil sector projects. Khatam ol-Anbia, the engineering and construction arm of the Revolutionary Guard Corps, withdrew lately from two key gas refinery projects. Industry sources were quoted saying that these projects were lagging behind schedule because foreign banks were not providing financing. By pulling out, the Revolutionary Guard hopes to head off further delays.

The impact on internal economic stability

Initial indications point to the potentially powerful effects of the sanctions on internal economic stability, in spite of Government's rhetoric.

Sources at the Tehran Chamber of Commerce were quoted saying that the sanctions could lead to a 1.8 per cent fall in the annual growth of the gross domestic product. That, combined with other effects, could mean negative growth and increasing unemployment. Other media reports quote a confidential study prepared for the Ministry of Commerce, estimating that more than 40,000 businesses are likely to go under as a result of the new sanctions, over the next three years.

However, the most outstanding challenge for the Iranian government, on the internal economic front, is the continuation and aftermath of subsidy reduction, which has started in December 2010.

The price of gasoline was raised fourfold, from the equivalent of 10 US cents to 40 US cents per liter for a basic allocation of 60 liter per month per car, and to 70 US cents per liter for additional quantities. The price of other petroleum products jumped as well (some of them as high as nine-fold); and the price of bread more than doubled.

This came as a second step – after issuing a first round of cash payments to Iranian households, designed to soften the impact of higher prices to come. The government committed itself to continue this program at a total annual cost of about USD 30 billion a year.

Following rounds of price increases, expected in the near future, include electricity bills (expected to triple), heating gas (expected to rise more than five-fold), transportation and many other basic products and services.

Production costs of energy-consuming industries such as cement and steel will go up dramatically a well, fuelling unemployment which already stands at about 15 per cent, and rising.

The overall impact on the general price level is predicted to be a jump of about 20 percentage points of inflation, in 2011; which would further destabilize the already high inflationary environment; as inflation in Iran has fluctuated between 10%-25% per annum in recent years.

At a price of 10 US cents per liter of gasoline, the prices of energy products in Iran were among the most heavily subsidized in the world. The overall burden of subsidies on government budget was estimated at between USD 75 – 100 billion; and unless handled, subsidies were forecasted (by the IMF) to cost the Iranian economy no less than about 4 percentage points of real annual GDP growth, and one third decline in oil exports in just a few years.

The new round of sanctions made this unbearable burden even much less sustainable, and has forced the government to act, in spite of the sensitive nature of this move.

President Ahmadinejad has rightly called the subsidy cut plan the "biggest surgery" in Iran's economy in half a century and vowed to fully cut all subsidies by the end of his term in 2013.

Hence, one can expect an on-going process of periodic increases in gasoline price, electricity tariffs, and prices of other energy products, coupled with secondary inflationary waves; which, in turn, would generate a continuous, prolonged atmosphere of economic instability.

Looking ahead

Looking ahead for the coming months, one should look for the impact of the sanctions on internal economic affairs, and especially the following issues:

- The continuation and aftermath of subsidy reduction, which are expected to be probably the hottest political issue in Iran; coupled with mounting difficulties in balancing the state budget.
- Continuation or changes in cash payments compensating for subsidy cuts; difficulties in execution and effectiveness of this mechanism.
- Indications for other effects on the standard of living of low-income classes, unemployment rates, etc.
- Shortage in various important consumption and industrial items: primarily oil products, but also critical imported products for industrial production, etc.
- Mounting pressure on the banking system, which may reflect on the stability of Iranian banks
- Difficulties in oil production and exports

Other indications recommended for close monitoring:

- Effects on the economic power and role of the Revolutionary Guard
- Effects on the positions of major political actors regarding the sanctions and how it should be handled, and possible effects on the Regime's relations with its close foreign allies (Syria, etc.)

Though the cumulative effect could harm Iran's economy to the point where domestic pressure compels Iranian leaders to start considering a compromise on Iran's nuclear policy, sanctions have not, to date, caused such an Iranian policy shift. One should note however, that US officials say that international sanctions has restricted Iran's ability to procure certain critical inputs / raw materials needed for its nuclear project.

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