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Iran: Efforts to Preserve Economic Benefits of the Nuclear Deal

Overview

On May 8, 2018, President Trump announced that the United States would cease implementing U.S. commitments under the 2015 multilateral Joint Comprehensive Plan of Action (JCPOA) with Iran. On November 5, 2018, at the end of a "wind down period," all pre-JCPOA U.S. sanctions on foreign firms that conduct transactions in all of Iran's core economic sectors, including energy, banking, shipping, and manufacturing, went back into effect. These include sanctions on "petroleum-related transactions" and transactions by foreign banks with Iran's Central Bank. In addition, 700 Iranian and third country entities have again been designated by the United States as sanctioned entities, meaning that foreign firms that transact business with these entities could face virtual exclusion from the U.S. economy.

The non-U.S. parties to the JCPOA—the United Kingdom, France, Germany, Russia, China, the European Union (EU) and Iran—opposed the U.S. move and have sought to preserve the accord. The outcome of their efforts may depend on the degree to which Iran perceives that it continues to receive economic benefits of the agreement. To date, Iran has continued to comply with the JCPOA, while pressing the EU and other parties to the JCPOA to provide assurances of continued economic engagement with Iran.

Iran Trade and Investment Post-JCPOA

Iranian leaders might abrogate the JCPOA if the economy suffers the effects of multilateral sanctions as during 2011-2015. During that time, Iran's crude oil exports dropped by more than half, and its total trade by value fell nearly 50%, according to International Monetary Fund data. In April 2015, then-Treasury Secretary Jacob Lew said Iran's economy was about 20% smaller than it would have been had sanctions not been imposed. Iranian officials have stated that avoiding a repeat of such economic damage depends, in particular, on maintaining the ability to export oil and receive payments in hard currency. Oil and petroleum products account for 80% of Iran's exports, and the proceeds are expected to fund half the 2018-19 budget.

Following adoption of the JCPOA, Iran's crude exports more than doubled, reaching a peak of 2.5 million barrels per day (bpd) in April 2018, according to Bloomberg data. As reimposition of U.S. sanctions approached, Iran's monthly exports dropped to 1.6 million bpd, as of October 2018. Asia, Iran's largest market, purchases more than 65% of Iran's crude exports (**Figure 1**); China is the largest importer, accounting for 32%, followed by India. During the escalation of sanctions in 2011-2015, Asian trading partners cut Iranian oil imports (to earn a U.S. sanctions exception for "significantly reducing" oil purchases), but did not follow the EU in imposing an embargo.

Iran's continued adherence to the JCPOA might hinge on whether it can generate enough oil revenue to avoid a severe recession—either through continued sales to the EU (Iran's top pre-sanctions trading partner) or through increased sales to Iran's non-EU customers. Since 2016, Europe accounted for more than a fifth of Iran's crude exports. From 2016 to 2017, exports to Europe grew nearly 50%; within the EU, Italy, Spain, and Greece have been the largest importers (**Figure 2**). However, by October 2018, EU imports fell to their lowest monthly level since 2016, falling 80%compared to October 2017, as most countries cut oil purchases from Iran. Other buyers, such as Japan and South Korea also cut purchases to zero.

Figure 1. Iran's Crude Oil Exports by Region

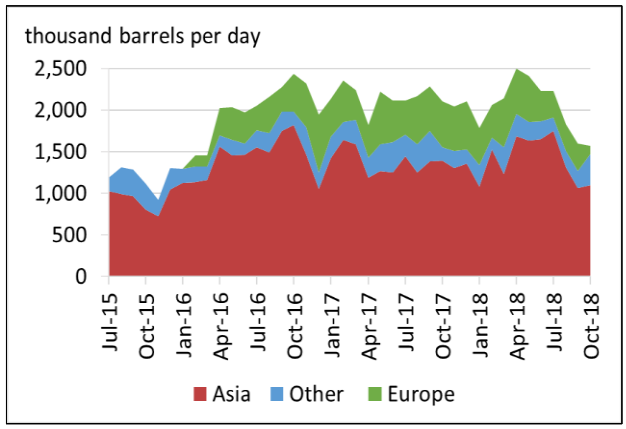
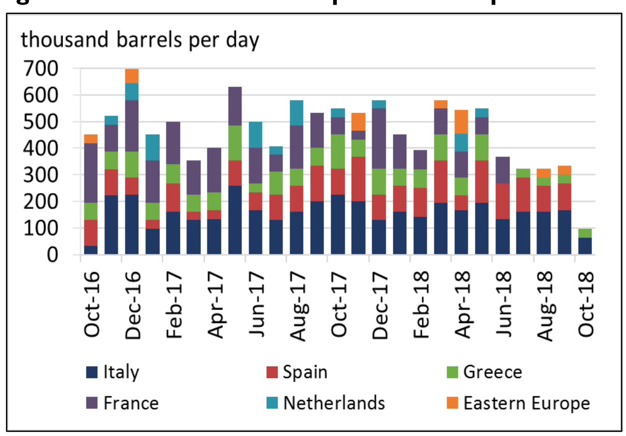


Figure 2. Iran's Crude Oil Exports to Europe



Sources: Bloomberg tanker tracking.

Since 2016, oil shipments to Europe had not surpassed pre-sanctions levels, unlike in China and India. Notably, in July 2018, China's monthly imports from Iran surpassed 800,000 bpd, and the Chinese share of Iran's exports grew to nearly 50% by October. While India's imports dropped in October, they have risen 25% year to date in 2018, compared to 2017. Whether these trends continue will have significant implications for Iran's ability to maintain oil exports above 2012-2016 levels.

After sanctions were eased in 2016, many foreign firms began to resume business ties and investments in Iran, including in the manufacturing, energy, and auto sectors. In 2017, foreign direct investment inflows to Iran increased by nearly 50% to $5 billion, according to the U.N. Conference on Trade and Development. Iran's imports also expanded by nearly 40% over 2015-2017. However, with re-imposed U.S. sanctions, EU and other foreign firms have begun to pull out of operations and investments in Iran. EU firms with extensive transatlantic business face higher risk of sanctions violations than those less integrated with the U.S.

JCPOA Preservation Efforts

Even if Iran's oil customer base shifts even more sharply toward Asia, EU countries have a substantial strategic and political stake in preserving the JCPOA. The leaders of France, Germany, and the UK (the three European countries that negotiated the JCPOA alongside the U.S., China, and Russia)—and the EU collectively—issued statements expressing "regret" over the decision. EU leaders stated that they remained committed to the JCPOA as "important for our joint security," and have consistently claimed that the JCPOA is a binding international commitment under U.N. Security Council Resolution 2231.

EU Efforts

The EU has taken a number of steps in an effort to maintain the economic benefits for Iran of the JCPOA. In June 2018, the EU updated a 1996 "blocking regulation" that seeks to shield EU firms from potential U.S. sanctions penalties by allowing EU firms to recover damages that arise from noncompliance. In practice, there have been few cases of enforcement, and few experts expect that measure, which entered into force on August 6, 2018, to persuade major firms to undertake the financial risks of violating sanctions.

In June 2018, the European Commission updated the EIB's external lending mandate of the European Investment Bank (EIB) to make Iran potentially eligible for EIB investments. Additionally, to help support Iran's economy, the European Commission adopted an €18 million package in August 2018 for "projects supporting sustainable economic and social development." This includes €8 million in assistance to the private sector, such as support for "high-potential" Iranian SMEs and technical assistance to Iran's Trade Promotion Organization. Further EU efforts may center on incentivizing small and medium-sized enterprises (SMEs) with less financial ties or exposure to the U.S. market to expand business ties.

Having unsuccessfully sought broad exemptions from the Trump Administration for EU firms that continue to do business with Iran, the EU has been working to develop a payment mechanism that would allow such firms to avoid U.S. sanctions. While the details of this proposed Special Purpose Vehicle (SPV) are yet to be finalized (including which country might host it), the SPV would act as a middleman in processing transactions, thereby allowing EU firms to avoid direct payments to and from Iran. For example, a company receiving oil exports from Iran would pay into the SPV, and that payment would then serve as a credit which Iran could use to purchase other goods from EU member states. However, it is not clear that European firms that transact business with Iran through the vehicle would avoid U.S. sanctions, which penalize even indirect forms of trade with Iran. On November 5, 2018, Italy and Greece received U.S. sanctions exceptions for "significant reductions" in oil purchases (SRE) and can import Iranian oil for six months without U.S. penalty.

Another source of U.S.-EU friction is a U.S. request that the Brussels-based SWIFT electronic payments network expel Iranian banks from its system. The EU wants Iran to remain within the network and has indicated it would not, as it did in 2012, ask SWIFT to remove Iranian banks. German Foreign Minister Heiko Maas has advocated for SWIFT to become more independent of the U.S and for the development of other independent European payment channels. Still, now that many Iranian banks are again designated by the United States for sanctions as of November 5, it is likely SWIFT will disconnect those banks from that network.

Role of Non-EU Countries

Non-EU countries are increasingly critical if Iran is to continue receiving the economic benefits of the JCPOA. China and India, Iran's two largest oil customers, were also granted a six-month SRE. China and India have indicated they will continue economic engagement, and recent data suggests the Asian buyers are beginning to absorb Iran's oil export volumes as other countries scale back. If China and India were to continue current levels of Iranian oil imports, it is possible that these two countries alone may keep Iran's exports high enough to help the country avoid a severe recession, even if other buyers, including Japan and South Korea, reduce their imports dramatically.

The shifts in Iran's oil export patterns might further increase Iran's reliance on China, which is already a top trading partner and source of financing and investments in infrastructure in Iran. Unlike the EU, the Chinese government has some capacity to direct firms, to continue transacting business with Iran despite U.S. sanctions. India and Iran have reportedly agreed to use India's currency, the rupee, as a means of maintaining economic ties. In addition, the Indian government announced it would permit state refiners to continue to import Iranian oil. Chinese state oil traders have also shifted to using Iran-operated tankers to deliver oil.

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