



August 7, 2018

## Will Iran's mounting troubles raise oil prices?

Not so long ago, things were looking up for Iran. The 2015 nuclear deal signed with the United States, the United Kingdom, France, Russia, China and Germany lifted tough sanctions on Iran in exchange for curbs on its nuclear program. This, among other things, permitted a sharp increase in Iran's oil production and unlocked tens of billions of dollars in frozen assets.

Iran's good fortune extended also into the geopolitical sphere. ISIS, a serious enemy of Iran, has been all but defeated. The Assad regime in Syria, a close ally of Iran, has been saved. Iraq, once a fierce geopolitical rival, is now a de facto ally since the overthrow of Saddam Hussein. Hezbollah, an Iranian proxy, is literally the power behind the throne in Lebanon. And, finally, Saudi Arabia, Iran's Sunni rival, is struggling with major economic and political challenges, not to mention being stuck in a military quagmire in Yemen against Iranian-backed rebels.

However, Iran's winning streak came to an abrupt halt last May when U.S. President Donald Trump followed through on his threat to withdraw from the nuclear deal. Worries over looming sanctions have already caused Iran's currency to crater and inflation to spiral out of control.

These economic difficulties have focused the Iranian public's attention back on the price being paid for Iran's geopolitical ambitions. Indeed, the more Iran spends its wealth abroad in the quest for influence, the more vulnerable it becomes to questions why this money would not be better spent at home. While the Iranian government is in no imminent danger of collapse, the fact that these questions are being raised is a sign of growing public discontent.

### U.S. sanctions re-imposed

The reasons given by the Trump administration for withdrawing from the nuclear deal are threefold:

- It did not cover Iran's missile program.
- It failed to address Iran's aggressive regional behaviour.
- It failed to guarantee unfettered access to Iranian military sites. (Under the deal, Iran had 24 days to permit an inspection. If it refused, an arbitration panel was to analyze the request.)

On August 6, the United States imposed restrictions on Iran's purchase or selling of dollars, automobiles, gold, and other precious metals. As of November 4, it will impose sanctions on Iran's oil exports and transactions with the central bank. Any company or individual that conducts business with Iran in breach of the sanctions could be subject to a fine and/or see their assets frozen.

**Despite the fact that the United States is the only country officially reinstating sanctions, the size of its economy and the importance of the U.S. financial system gives it considerable leverage. A business forced to choose between doing business with Iran and having access to the U.S. market and financial system will almost certainly choose the latter.** Indeed, the European Union's opposition to the sanctions has not stopped many large European companies from winding down their trade ties with Iran.

Iran's best hope is to see the void filled by small- and medium-sized European companies that do not do business with the United States. However, even under the best of scenarios, they would not come close to replacing the revenues lost from the departure of larger European companies.

## Can China step in and save Iran?

While Europe, Japan, South Korea and even India have indicated their willingness to reduce oil imports from Iran, China has so far publicly resisted any cutbacks. China is the world's largest buyer of Iranian crude. It imported 718,000 barrels per day (bpd) on average from January to May of this year, amounting to more than one-quarter of Iran's oil exports.

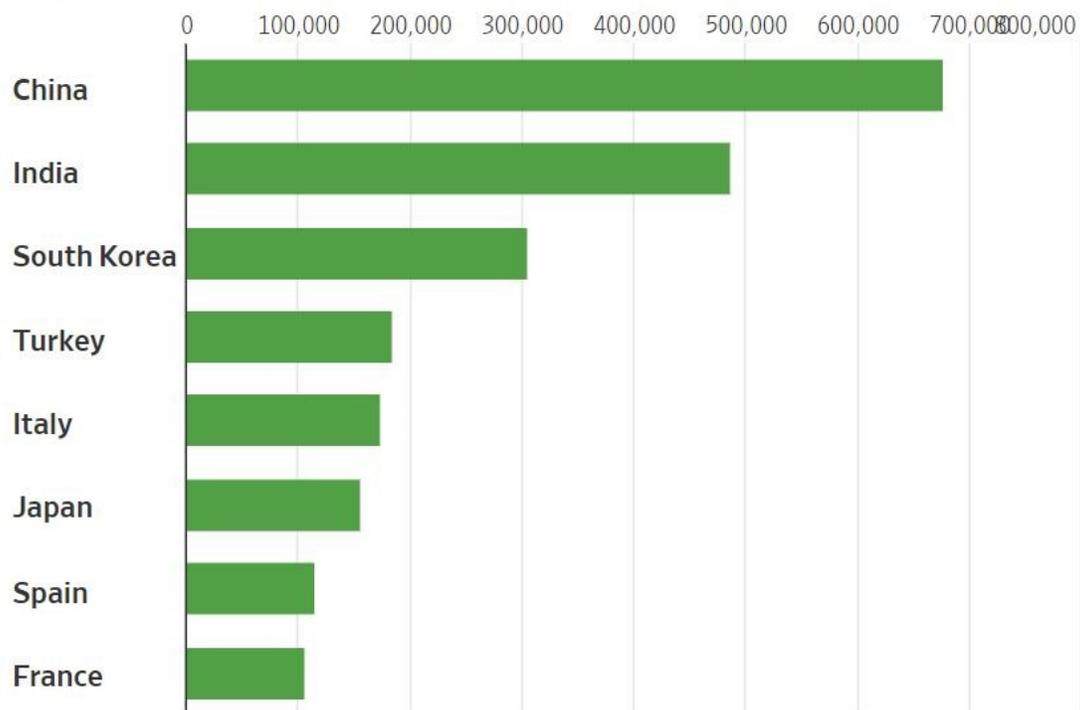
However, Iran faces four main challenges where China is concerned:

- Major Chinese companies that are exposed to the U.S. market and/or that conduct business in U.S. dollars will inevitably be forced to curtail their exposure to Iran.
- While China has refused to cut back on its purchase of Iranian oil, it has reportedly agreed not to increase how much it buys.
- China's attempts to circumvent sanctions by facilitating yuan-denominated trading through mostly smaller companies with no exposure to the United States will raise costs for Iran throughout the supply chain. These smaller companies lack the economies of scale and efficiencies of their larger counterparts.
- China will no doubt take advantage of Iran's weak negotiating position by attempting to purchase Iranian oil at a heavy discount.

### Big Buyers

Major importers of crude oil from Iran

Average monthly imports, in barrels a day,  
June 2017 – June 2018



Source: Vortexa

Source: "Can Iran Circumvent U.S. Sanctions?" OilPrice, July 26, 2018

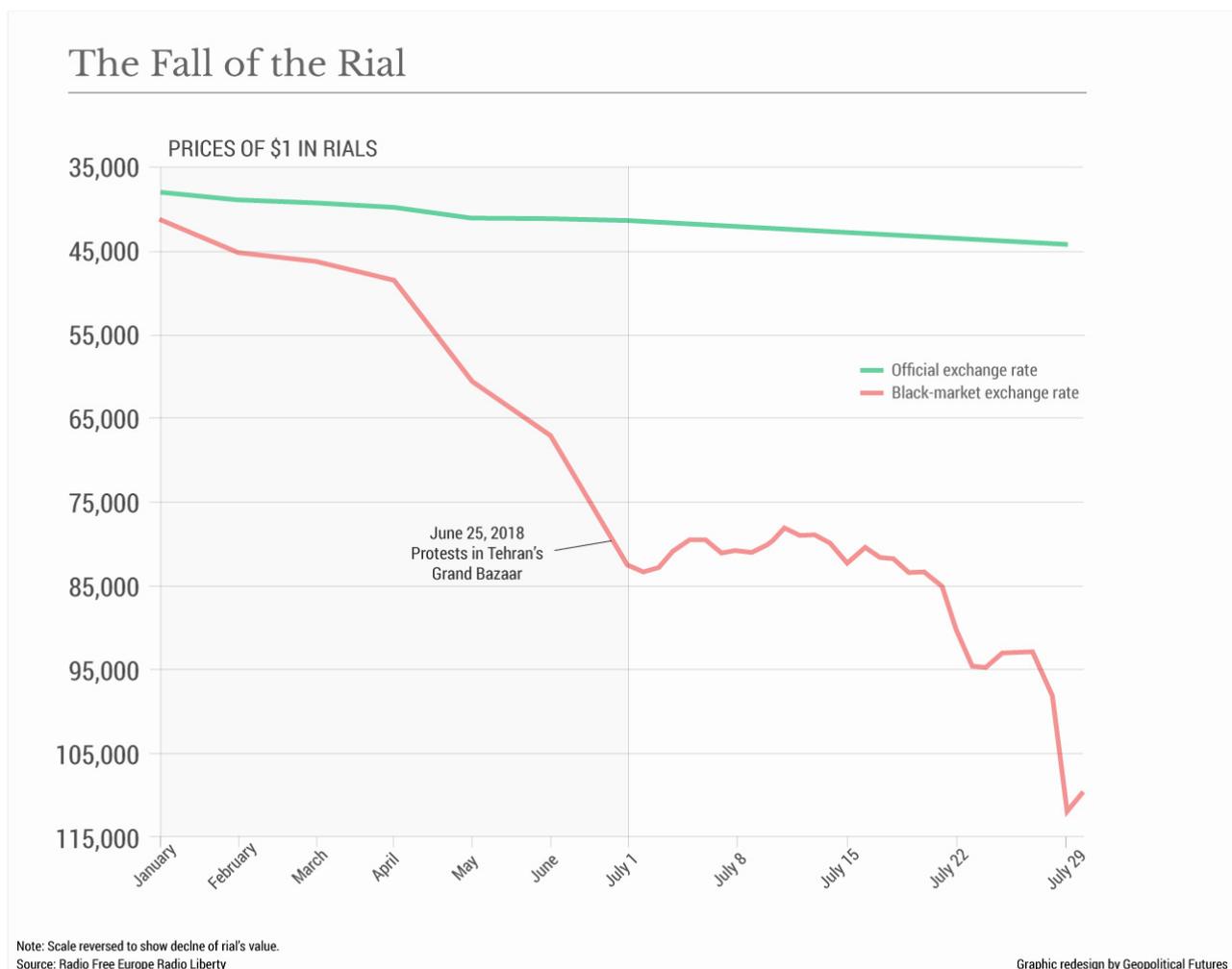
## The Iranian economy takes a turn for worse

When the first set of sanctions were in effect, GDP growth in Iran went from close to 6% in 2010 to 1.5% contraction in 2015. Inflation surged, the national currency lost nearly two-thirds of its value, and food and medicine shortages were commonplace.

After certain sanctions were lifted following the signing of the 2015 nuclear deal, GDP grew 12.5% in 2016 and over 4% in 2017.<sup>1</sup> Before America's withdrawal from the nuclear deal, BMI Research, a branch of the Fitch Group, had forecast economic growth of 4.3% for Iran in 2018. BMI is now projecting the economy will grow by only 1.8% this year and contract 4.3% in 2019.

The first casualty of looming U.S. sanctions is Iran's currency, the rial. From May 8 (date of the U.S. withdrawal from the nuclear deal) to the end of July, its value against the U.S. dollar dropped by half.<sup>2</sup> Year to date, the currency has lost 80% of its value.

In a failed attempt to stabilize the currency, the government made it illegal for anyone to trade outside the official rate (see chart below) and banned the import of 1,300 foreign goods. The use of the black market rate remains widespread.



Source: "Preparing for the Worst in Iran," Geopolitical Futures, July 31, 2018

To make matters worse, Iran is currently suffering its worst drought in 30 years.<sup>3</sup> This is forcing the country to import much more food at a time when its currency is severely devalued. This is in addition to the large quantities of medicine and consumer goods it already imports on a regular basis. The drought also means that there has been less water to drive Iran's hydroelectric plants, which has resulted in major power shortages.

<sup>1</sup> IMF data

<sup>2</sup> "Iran's Rial at Historic Low as U.S. Sanctions Loom," Wall Street Journal, July 30, 2018

<sup>3</sup> UN Food and Agriculture Organization, 2018

## ***Not surprisingly, the devalued currency has caused a spike in inflation.***

Economist Steve Hanke of John Hopkins University, an expert in global exchange rates, has estimated Iran's annual inflation rate to be 221%, far above the official government rate of 10.2%.<sup>4</sup> Iran's official unemployment rate is 12%, but unofficial estimates put it much higher. The official rate for youth unemployment is about 30%.

Finally, although Iran has about \$90 billion in reserves,<sup>5</sup> easily accessible reserves are reported to be much lower.<sup>6</sup>

## **How much will crude oil production decline?**

When the first round of sanctions went into effect before the first nuclear deal was reached, Iran's production plunged from nearly 4 million bpd in 2010 to a low of 2.5 million bpd in mid-2014. After certain sanctions were lifted in 2016, production quickly bounced back to nearly 4 million bpd.<sup>7</sup> Exports jumped from a low of 1 million bpd in 2015 to a recent high of 2.7 million bpd in May 2018.

There is a growing view that the United States will be more aggressive than originally thought in its enforcement of the new sanctions. This has prompted many analysts to revise upward their estimates of how much Iranian oil exports will drop from about 500,000 bpd a few months back to closer to 1 million bpd today. Due to companies preparing for the looming sanctions, Vortexa, a London-based consulting firm, estimated that Iran's exports have already fallen from an average 2.7 million bpd in May to 2.2 million bpd in June.<sup>8</sup> Iran's Mehr news agency reported in July that the state oil company expected exports to decline by 500,000 bpd this year, with some Iranian officials privately predicting the drop will be closer to 1 million bpd.<sup>9</sup>

## **For the first time since 2009, Iran hit by wave of protests**

In December and January, demonstrations erupted in more than 100 Iranian cities and towns over inflation, joblessness, proposed cuts to social programs, and corruption. The protests resulted in 25 deaths and close to 5,000 arrests.

In March, farmers from Isfahan Province in central Iran protested government inaction in the face of the long drought. In May, truckers went on a nationwide strike to protest stagnant wages and rising costs. These protests spread to over a 100 cities. In late June, shopkeepers and merchants in Tehran and 24 other cities organized protests for three days over the devaluation of the Iranian currency, which is preventing them from importing many goods.

Adding to the unrest is the fact that hundreds of thousands of Iranians have recently suffered financial losses owing to the collapse of numerous poorly regulated credit institutions. The institutions in question were owned and managed not by financial experts but by people with close ties to the ruling clerics and the Revolutionary Guard.

Underlying all these protests is the question why so much of the country's wealth continues to be used to support groups in Yemen, Lebanon, Gaza, and Syria, while the needs of the Iranian people are neglected at home. Estimates of Iran's military spending in Syria alone range from \$6 billion to \$20 billion annually.<sup>10</sup>

## ***How these protests differ from previous major protests in 2009***

The anti-government uprising in 2009 drew more than a million protesters to the streets to protest the disputed re-election of conservative President Mahmoud Ahmadinejad. It was led mostly by the educated middle class and was concentrated in Tehran, Iran's capital.

In contrast, the recent protests attracted far fewer people (rarely more than a few thousand at any given time) but were much more widespread across the country. They were also driven largely by angry working-class young people in areas that have traditionally been a bedrock of support for Iran's ruling clerics. Half of Iran's population (80 million) under the age of 30.

## **Iran's response to U.S. sanctions**

Despite the fact that sanctions will not be fully re-imposed for several months, it is highly unlikely a new agreement will be reached in the near term.

<sup>4</sup> "Iran's Rial Is In A Death Spiral, Again," Forbes, July 29, 2018

<sup>5</sup> "Preparing for the Worst in Iran," Geopolitical Futures, July 31, 2018

<sup>6</sup> "Iran clamps ceiling on dollar holdings in effort to support rial," Reuters, April 10, 2018

<sup>7</sup> "Sorry, Iran, China Isn't Going to Save You," Bloomberg, June 27, 2018

<sup>8</sup> "U.S. Toughens Stance on Future Iran Oil Exports," Wall Street Journal, June 26, 2018

<sup>9</sup> "Iran eyes Asia buyers to protect oil exports from US sanctions," Financial Times, July 15, 2018

<sup>10</sup> "Iran's complex of crises catches up with the regime," Asia Times, January 3, 2018

For one thing, the United States has announced very stringent conditions for a new agreement. It wants a commitment from Iran on three points: It must cease enriching uranium (even at very low levels); it must stop ballistic missile testing; and it must change its military stance in Syria, Lebanon and Yemen. These are all considered red-line issues for Iran.

In the short term, Iran could respond to U.S. sanctions by increasing support to its proxies across the Middle East, resuming long-range ballistic missile testing, and expanding its uranium enrichment capacity. At this moment in time, Iran will not formally withdraw from the nuclear accord because doing so would force the EU to reinstate sanctions. Iran perhaps also realizes that formal withdrawal from the accord would increase the risk of seeing Saudi Arabia, Turkey and Egypt setup their own nuclear weapons programs.

Tensions with Israel are also mounting. Iran remains determined to incorporate Syria in its sphere of influence. Israel has made it clear that it does not intend to tolerate an Iranian military presence in Syria and has launched several deadly airstrikes on Iranian military installations inside Syria.

Over the longer term, the United States is hoping that growing public discontent and the impact of new sanctions will pressure the Iranian government to redirect wealth from foreign adventures to domestic needs. If this happens, Iran could then be more easily persuaded to make painful compromises with the United States. Perhaps with this in mind, President Trump recently said he was willing to meet with Iran's leadership, without preconditions. Iranian President Hassan Rouhani responded by saying there could be no talks as long as Washington was renegeing on the 2015 nuclear deal.

## Iran's threat to block the Strait of Hormuz

More than 30% of the world's oil tanker traffic (18.5 million bpd) passes through the Strait of Hormuz, a narrow channel between Iran and Oman that connects the Persian Gulf to global waterways. It is about 33 miles wide at its narrowest point.

The Middle East's biggest oil exporters depend on the Strait of Hormuz to move the vast majority of their crude oil shipments. Despite Iran's threats, its near-total reliance on the Strait of Hormuz to ship oil exports and the presence of the U.S. Navy in the area are two reasons why Iran is very unlikely to actually attempt a blockade. However, even the mere threat of a blockade could temporarily send oil prices higher.



THE WASHINGTON POST

Source: "The oil route that could be behind the escalating Trump-Iran threats," Washington Post, July 24, 2018

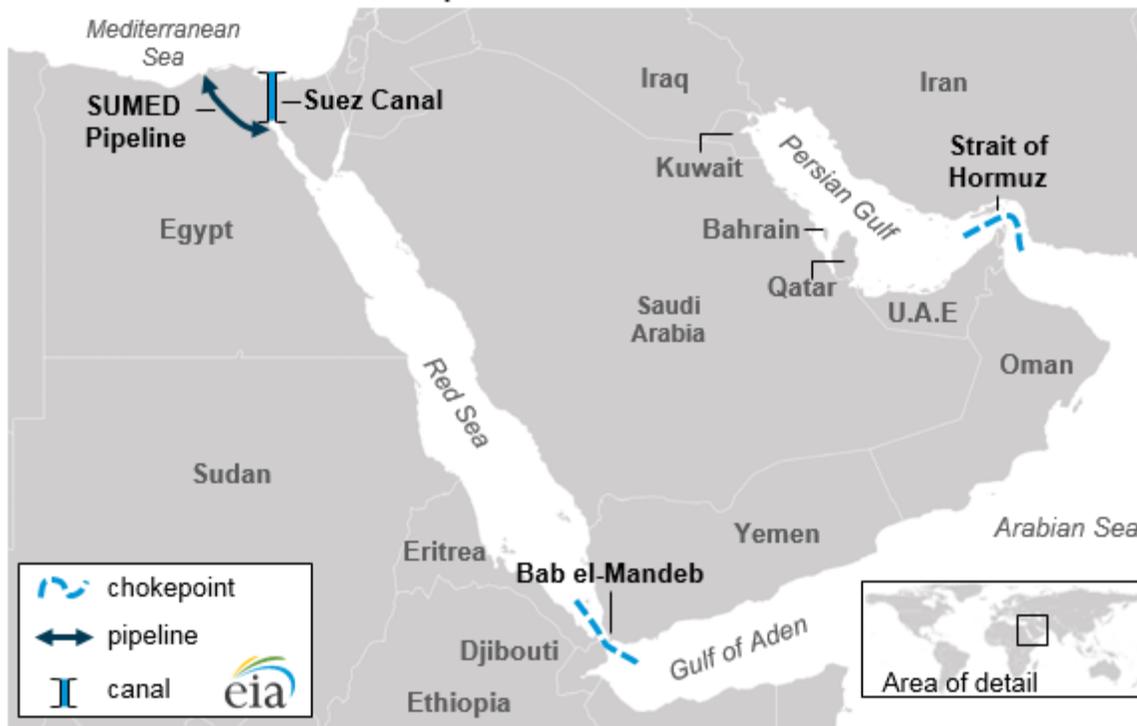
## Conclusion

The re-imposition of U.S. sanctions has not only roiled Iran's economy, it has placed the country in a very precarious geopolitical position. The more it strives to achieve geopolitical objectives and make life more difficult for the United States and its allies in the Middle East, the more likely its economy will continue to suffer. The greater the economic duress, the more Iranians will ask why funds are being diverted from pressing domestic needs to finance foreign adventures.

**While we feel that a direct conflict between Iran and the United States remains highly unlikely, tensions between the two countries look set to worsen in the short term.** The United States will continue to squeeze Iran economically and Iran will likely strike back against the U.S. and its allies through its various proxies.

The recent decision by Saudi Arabia to temporarily halt oil shipments through the Bab al-Mandeb Strait (see map below) after Saudi Aramco reported attacks from Iranian-backed Houthi rebels on two oil tankers may already be an outcome of Iranian retaliation. Almost 5 million barrels of crude and refined petroleum products pass daily through this waterway to the Red Sea and onward to the Mediterranean.

**Arabian Peninsula maritime chokepoints**



Source: "Three important oil trade chokepoints are located around the Arabian Peninsula," EIA, August 2017

Over the longer term, it is possible a combination of financial, political and limited military pressure will bring Iran back to the negotiating table. It is important to note that, despite its history of repression, the regime is more vulnerable to public opinion than the governments of many other Middle Eastern countries. Women tend to have more rights there than elsewhere in the region, and it is one of the few countries in the region to hold elections, however imperfect they may be. The supreme leader, who is selected by a body of 86 clerics, appoints the judiciary and the Guardian Council, which must approve all candidates for public office, including the presidency.

Finally, where the global oil sector is concerned, predictions that Iran's oil exports could drop by as much as 1 million bpd leaves oil prices particularly vulnerable to further disruptions from other countries such as Libya, Nigeria and Venezuela, where OPEC estimates that production has fallen from 2.154 million bpd in January 2016 to only 1.34 million bpd in June. The IMF's estimates that Venezuela's economy has shrunk 45% since 2013 and that it will contract another 15% in 2018. This makes further reductions in Venezuelan oil production very likely.

Angelo Katsoras

## Economics and Strategy

### Montreal Office

514-879-2529

#### Stéfane Marion

Chief Economist and Strategist  
stefane.marion@nbc.ca

#### Matthieu Arseneau

Deputy Chief Economist  
matthieu.arseneau@nbc.ca

#### Krishen Rangasamy

Senior Economist  
krishen.rangasamy@nbc.ca

#### Paul-André Pinsonnault

Senior Fixed Income Economist  
paulandre.pinsonnault@nbc.ca

#### Marc Pinsonneault

Senior Economist  
marc.pinsonneault@nbc.ca

#### Kyle Dahms

Economist  
kyle.dahms@nbc.ca

#### Jocelyn Paquet

Economist  
jocelyn.paquet@nbc.ca

#### Angelo Katsoras

Geopolitical Analyst  
angelo.katsoras@nbc.ca

### Toronto Office

416-869-8598

#### Warren Lovely

MD & Head of Public Sector Strategy  
warren.lovely@nbc.ca

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