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## The Limits to Iran's Geopolitical Ambitions

There is no denying that Iran is on a geopolitical winning streak in its quest for regional dominance. ISIS, a serious enemy of Iran, has been all but defeated. The Assad regime in Syria, a close Iranian ally, has been saved. Iraq, once a geopolitical rival, is now a de facto ally thanks to 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, as recent protests have shown, these geopolitical gains have come at a price. Indeed, the more Iran spends its wealth abroad in the quest for influence, the more it becomes vulnerable to questions why this money would not be better spent at home. Iran's still fragile economy only reinforces this dynamic. **While the Iranian government is in no imminent danger of collapse, the fact that these questions are being raised and protests have been held is a sign of growing public disillusionment.**

### The most recent outbreak of protests

Protests began in late December in Mashhad, Iran's second-largest city, and spread to over 70 cities and towns before subsiding in early January. The protests, which resulted in over 20 deaths and close to 4,000 arrests, first targeted economic conditions and later morphed into a general condemnation of the government. Some protesters reportedly went so far as to chant: "Death to Hezbollah" (Iran's Shiite mercenary army in Lebanon), "Death to the dictator," (Iran's supreme leader, Ali Khamenei) and "Let go of Syria, think about us".<sup>1</sup>

One of the triggers for the demonstrations was the government's decision last December to publish details of the budget for the first time. It revealed that the government planned to reduce subsidies for the poor by 45% and increase fuel prices by as much as 50% all the while substantially increasing spending on religious institutions and defence.<sup>2</sup> The cuts in subsidies would apply to anyone making more than \$194 a month, thereby impacting more than 30 million people.<sup>3</sup>

This came on top of anger over financial losses suffered by hundreds of thousands of Iranians in recent years owing to the collapse of many badly regulated credit institutions offering guaranteed returns on investments that, in hindsight, proved too good to be true. 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.

All of this has led many Iranians to wonder why so much of the country's wealth has gone to support groups in Yemen, Lebanon, Gaza, and Syria, while their needs are neglected at home. Estimates of Iran's military expenditure in Syria alone vary from \$6 billion to \$20 billion annually.<sup>4</sup>

### *How these protests differ from the last 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. They were led mostly by the educated middle class and were concentrated in the streets of Tehran, Iran's capital.

**In contrast, the recent protests attracted far fewer people (rarely more than a few thousand in any specific locality) but were much more widespread across the country. They were also largely driven 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) is under 30 years of age.

In what is perhaps a sign of how much these demonstrations have shaken the authorities, Iran's leaders have been surprisingly conciliatory in their public statements. For example, even as he blamed foreign powers for the protests, the Iranian Supreme Leader Ayatollah Ali Khamenei said that people had genuine grievances that should be addressed. President Rouhani went even further, stating: "One cannot force one's lifestyle on the future generations."

<sup>1</sup> "Iranian and Saudi Youth Try to Bury 1979," New York Times, January 9, 2018

<sup>2</sup> "Iran Protests: What's Really at Stake," Geopolitical Futures, January 11, 2018

<sup>3</sup> "Growing dissent adds to Iranian regime's troubles," Financial Times, January 5, 2018

<sup>4</sup> "Iran's complex of crises catches up with the regime," Asia Times, January 3, 2018

## Iran's still fragile economy

After a long period of little growth, the Iranian economy picked up thanks to the lifting of certain sanctions following the 2015 nuclear deal. Real GDP went from a contraction of 1.3% in 2015 to 12.5% growth in 2016. The IMF has projected that the Iranian economy would grow 3.5% in 2017 and 3.8% in 2018. Despite this return to growth, many underlying problems remain:

- **Unemployment** is officially at 11.7%. Unofficially, however, it is estimated to be twice as high. As for youth unemployment, it officially stands at 24.4%, while the unofficial rate is thought to be closer to 40%.
- **Inflation:** Although inflation is well below its peak of 45% in 2013, it still stands at an uncomfortably high level of 10%. There has also been a 40% increase in the price of poultry and eggs due to the culling of millions of birds over avian flu fears and an increase in the cost of imported feed. One of the drivers behind higher feed costs is the depreciation of the Iranian rial, which has dropped from 25,000 per USD in 2014 to 36,000 as of January 11. While Iran's benchmark interest rate stands at a painful 18%, lowering it would further weaken its currency and make imports even more costly.<sup>5</sup>
- **Foreign direct investment:** While FDI in 2016 did increase by 64% from 2015, it is still well short of anticipated levels because of residual sanctions that remain in effect, particularly measures imposed by the United States. This continues to dissuade many companies from investing in Iran.
- **Economic growth has not been distributed equally.** Most of the profits from increased oil sales have gone to government elites and the Revolutionary Guard. According to some estimates, the Revolutionary Guard controls anywhere from 20% to 40% of the economy and pays nowhere near the same level of tax as other businesses.<sup>6</sup> The Guard was formed after the 1979 Islamic Revolution to protect the Islamic republic. It operates parallel to the country's regular armed forces and, since the 80s, has expanded into the private sector.
- **Water scarcity:** Water shortages have caused millions of people to move from rural areas to cities throughout the country. In January, the director of Iran's Drought and Crisis Management Centre said that 96% of the country's land area was experiencing prolonged drought conditions. **The option of building several desalination plants would cost Iran tens of billions of dollars.**

## Debt levels

One bright spot for Iran is its relatively low level of public debt which, according to the IMF, amounts to about 42% of GDP. Further, the vast majority of this debt is denominated in its own currency. Another positive is Iran's foreign reserves. These have risen substantially in the past few years in large part to the unfreezing of funds held abroad following the 2015 nuclear deal. **However, going forward, it will be much harder for these reserves to grow without a significant increase in oil prices and/or a politically difficult reduction in government spending.**

### Iran's International reserves have increased substantially

(Gross international reserves 2017)



<sup>5</sup> "Iran Protests: What's Really at Stake," Geopolitical Futures, January 11, 2018

<sup>6</sup> "Iran may try to loosen Revolutionary Guard's grip on economy," Associated Press, January 21, 2018

## Oil production

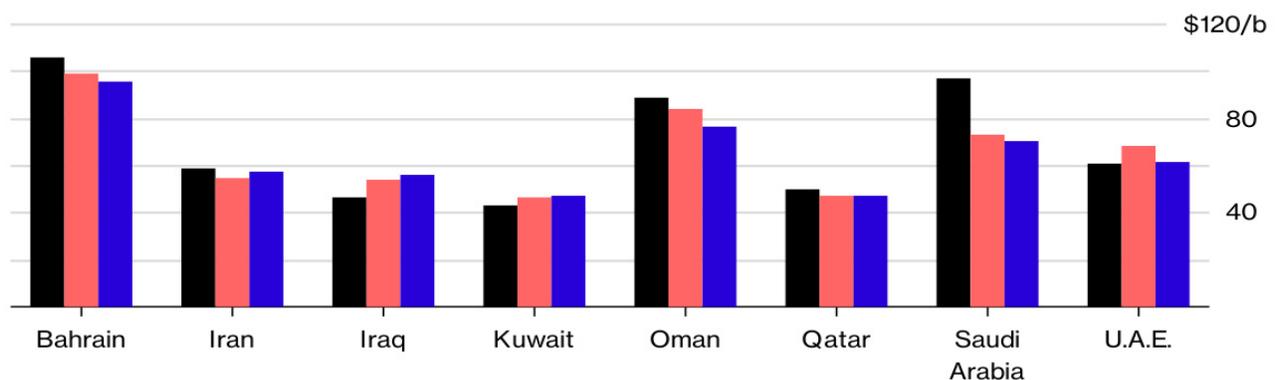
Iran is the world's fifth-largest producer of oil (4% of global supply). It produced an average of 3.8 million barrels per day (bpd) at the end of 2017, up from just under 3 million bpd in mid-2014. Exports jumped from about 1 million bpd in 2015 to about 2.1 million bpd in 2017.<sup>7</sup> This increase in production and exports is largely the result of sanctions being lifted on oil exports. Iran is aiming to produce 4.5 million bpd within five years. It will likely increasingly rely on China, the largest buyer of Iranian oil, to fund this expansion.

The IMF estimated that Iran needed an oil price of at least \$51 a barrel in 2017 to cover government expenditures. It is important to note, however, that Iran's penchant for secrecy with regard to budgetary matters (i.e., the cost of financing its geopolitical ambitions) makes this estimate highly speculative.

## Spending Too Much

Middle East oil producers need spending cuts to lower break-even levels

■ 2016 ■ 2017 est. ■ 2018 est.



Source: International Monetary Fund

**Bloomberg**

## Iran's complicated politics

Iran's governing structure is a complicated combination of Shiite Islamist theocracy and limited parliamentary democracy. At the very top of the power structure is the supreme leader, who is selected by the Assembly of Experts, a body composed of 86 clerics. The supreme leader appoints the judiciary and the Guardian Council, which must approve all candidates for public office, including the president. The supreme leader and the Guardian Council also have veto power over all legislation and control over the armed forces.

Below the supreme leader and the Assembly of Experts are the president and the parliament, which the population gets to elect every four years. While there have been many reported instances of fraud, recent elections have been considered legitimate.

It is also important to note that despite the regime's history of repression, Iran is more open than many other countries in the Middle East. Women tend to have more rights there than elsewhere in the region, and it is one of the few countries that hold elections, albeit imperfect ones.

## U.S.-Iran tensions and the 2015 nuclear accord

In 2015, Iran accepted constraints on its nuclear program in return for sanctions relief. The problem is that sanctions, in particular U.S. measures, have been only partially lifted.

In October, U.S. President Trump said Iran had failed to live up to the spirit of the pact but stopped short of re-imposing U.S. sanctions on Iran's energy industry. The United States is required by law to certify every 90 days whether Iran is complying with the 2015 agreement. After threatening to pull out of the deal, Trump decided on January 12 to continue honouring it.

<sup>7</sup> "Iran's working class, facing dim prospects, fuels unrest," Associated Press, January 6, 2018

However, Trump has promised not to recertify the deal again unless major changes are made to the agreement. These include giving international inspectors greater access to examine all military sites in Iran, adding more restrictions on the country's long-range missile program and pushing back the date when Iran can legally recommence higher levels of nuclear enrichment. This means that the European Union, the United States, China and Iran have until May to improve the deal and potentially avoid U.S. sanctions being reinstated.

Even if the United States was the only country to reinstate sanctions, its leverage would still be considerable because most crude sales are USD denominated, which means they are cleared by the U.S. banking system. Energy analysts estimate that the re-imposition of U.S. sanctions could remove 300,000 to 500,000 bpd of Iranian oil from the global market.

Even if the United States pulled out, we feel Iran would still abide by the deal in order to maintain its ties with the other signatories. For instance, unlike the United States, the EU has already completely lifted its economic sanctions. If Iran withdrew from the accord and expelled nuclear inspectors, the EU could be forced to reinstate sanctions. Iran also realizes that a formal withdrawal from the accord would increase the risk of Saudi Arabia, Turkey and Egypt beginning their own nuclear weapons programs.

**Ironically, one of the factors that has exacerbated tensions between the United States and Iran has been the defeat of ISIS.** During the battle against ISIS, the two geopolitical rivals were de facto partners. When their common enemy was defeated however, Iran went back to trying to broaden its sphere of influence in the Middle East and the United States went back to trying to contain it.

## The proxy war between Saudi Arabia and Iran

Despite increased tensions, a direct war between Iran and Saudi Arabia remains unlikely in the near term. Iran has just emerged from a long period of sanctions and is in no position to bear the financial burden of a direct conflict with Saudi Arabia potentially backed the U.S. Further, its proxy, Hezbollah, is still fighting in Syria and dealing with the financial burden of paying medical costs and benefits to the wounded and the families of those killed.

As for Saudi Arabia, its military is currently bogged down in Yemen and is nowhere near ready for another war. What's more, it would likely not be able to win a conflict against Iran's battle-hardened army without immediate assistance from a war-weary United States. Finally, such a war would throw a massive wrench into Saudi Arabia's highly ambitious plans to reform its economy.

**One scenario that could ignite a direct conflict is if a ballistic missile fired from Yemen caused significant casualties in Saudi Arabia. Given that the Saudis have already accused Iran of supplying missiles to Houthi rebels, they could hold Iran accountable for any deaths on its territory.**

## Conclusion

While Iran has realized major geopolitical gains in the Middle East, the Iranian people are coming to the realization that they have come at the expense of funds being diverted from pressing domestic needs. The country's high unemployment rate, double-digit inflation, wave of bank failures, unequal distribution of wealth, proposed cuts to social programs and water shortages have brought this into sharp focus. Further, a recent BBC report found that Iranians had become 15% poorer in real terms over the past decade. **We feel all these factors will eventually force Iran to moderate its geopolitical ambitions.**

**Iranian authorities will seek to curb public unrest not only through mass arrests but also by backtracking on certain proposed cuts to the social safety net. The obvious way to fund such spending would be to increase oil exports and cheat on its OPEC quota—an option made all the more appealing by the recent hike in oil prices. Another option would be to draw down from the country's foreign reserves.**

A close watch should be kept for signs of growing dissension within the government. For example, reports that Iran's Supreme Ayatollah Ali Khamenei supports forcing the country's powerful Revolutionary Guard to sell off their business holdings could raise tensions, particularly if the Guard seek to oppose the move.

Finally, despite Trump's threat to cancel America's participation in the nuclear deal and to reinstate sanctions on oil sales, we feel Trump's national-security team will ultimately persuade the President to maintain the deal in return for more sanctions targeting individuals/companies connected to the missile program and Iranian proxies such as Hezbollah. The last thing the United States needs is to have to deal with heightened tensions with Iran when it is still struggling to contain North Korea.

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# Geopolitical Briefing

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