ECONOMICS OF LIFTING SANCTIONS ON IRAN

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Introduction: July has been unusually active for the global economy this year. First, there was Greece’s debt crisis, a referendum on the terms of a bailout, and ensuing negotiations over debt relief. Next, China’s stock market plunged by about 30 percent from its mid-June peak, stoking fears that the growth slowdown may be sharper than expected. Finally, Iran and the Permanent Members of the UN Security Council and Germany (P5+1) reached a deal on July 14, 2015 that limits Iranian nuclear activity in return for lifting all international sanctions that were placed on Iran (Box 1).

Box 1. International sanctions on Iran since 2012

2012 July - European Union boycott of Iranian oil exports comes into effect.
2012 October - Iran’s currency, the Rial, falls to a record low against the US dollar, losing about 50% of its value since 2011. EU countries announce further sanctions against Iran focusing on banks, trade and gas imports and freezing assets of individuals and companies that supply Iran with technology.
2013 November - Iran agrees to curb uranium enrichment above 5% and give UN inspectors better access in return for about $7 billion in sanctions relief at talks with the P5+1 group - US, Britain, Russia, China, France and Germany - in Geneva.
2015 April - Iran and the EU reach a nuclear framework agreement and set for a final agreement in July 2015 with attendant lifting of the EU and the US sanctions on Iran.
2015 July 14th - The P5+1 group reach an agreement with Iran on limiting Iranian nuclear activity in return for the lifting of sanctions.
2015 July 20th - The U.N. Security Council unanimously approved the July 14th agreement.

Source: International media sources.

This issue of the MENA Quarterly Economic Brief (QEB) traces the economic effects of the latter development—removing sanctions on Iran—on the world oil market, on Iran’s trading partners, and on the Iranian economy. The removal of sanctions following the nuclear deal reached on July 14, 2015, and the opening up of the Iranian economy will impact the global and national economies through various channels.

The tightening of sanctions in 2012, which banned the purchase and transport of Iranian crude oil and natural gas to the EU, clearly affected the oil sector in Iran. In one year, Iran’s oil exports declined from 2.8 mb/d in July 2011 to below 1 mb/d in July 2012 (Figure 1). The most significant change post sanctions globally will be Iran’s return to the oil market. While it will take time to resume oil production because of under investment in the sector, most observers predict that in 8 to 12 months, Iran’s crude oil exports can reach pre-2012 levels, adding one million barrels a day (mb/d) to the already over supplied oil market. The World Bank estimates that the coming back of Iran to the oil market, assuming no response from other oil exporters, would lower oil prices by 14 percent or $10 per barrel in 2016.
The World Bank estimates that a drop of $10 in oil prices could worsen the fiscal balances of major oil exporters in the MENA region, to the tune of 5 percent of GDP in Saudi Arabia and 10 percent of GDP in Libya. This amounts to a loss of $40 billion for Saudi Arabia and $5 billion for Libya in annual oil export revenues. Iran will be the least affected oil-exporting country as the additional revenues from increased exports of oil will outweigh the negative impacts of falling oil prices. The current account balances of all MENA oil exporters will also worsen. Meanwhile, oil importers will benefit from the reduction in world oil prices. Being the largest oil importers, the EU and US will gain the most in absolute terms, although not much as a share of their GDP.

While the resumption of Iran’s oil exports to pre-2012 levels will take time, the immediate reaction of the oil market could be to take into account Iran’s 30-40 million barrels of stockpiled crude oil and condensate stored in the Persian Gulf that could easily be exported. Thus, the short term impacts on oil prices will still be a decline but less than what is estimated when Iran’s exports get back to full throttle.

Secondly, once sanctions and restrictions on financial transactions are relaxed, Iran’s trade, which had both declined in absolute terms and shifted away from Europe towards Asia and the Middle East, will expand. Iran’s cost of doing trade will also fall, increasing not just the volume but the value of its oil trade and non-oil trade. The World Bank estimates that, eventually, Iran’s trade will increase by about US$17 billion, equivalent to 3.5 percent of its GDP. Our analysis suggests that the countries that will see the largest post-sanctions increase in trade with Iran include Britain, China, India, Turkey, and Saudi Arabia. The findings of this report show that trade could shift towards European countries in the post-sanctions era. Expansion in exports and imports could also positively affect Iran’s bilateral trading partners’ economies, particularly the EU and UAE, and boost economic growth.

Thirdly, foreign direct investment (FDI), which had declined by billions of dollars following the tightening of sanctions in 2012, is expected to pick up. There has already been some interest shown by foreign multinationals since the April 2015 framework agreement, especially in the oil and gas sectors. The World Bank expects FDI to eventually increase to about $3 - 3.5 billion in a couple of years, double the level in 2015 but still below the peak in 2003. The majority of FDI, however, will go to the oil sector which is highly capital intensive and not capable of creating jobs for the large segment of unemployed. Data on greenfield FDI inflows to Iran shows that during 2011, foreign investment in real estate created 10 times more jobs than FDI inflows in the extractive industry.

Finally, the Iranian economy, which was in recession for two years, will receive a major boost from increased oil revenues—conservatively estimated at about $15 billion in the first year—and lower trade costs. In addition, there are estimates that Iran holds about $107 billion worth of frozen assets (including LCs and oil exports earnings) overseas, of which an estimated $29 billion will be released immediately after sanctions removal. In addition to slowing down, the Iranian economy underwent a structural shift during the sanctions era, with the oil, automobile, construction and financial sectors declining the most. As sanctions are lifted, these sectors as which were not be able import parts and machinery due to sanctions in the past two years, are likely to see an expansion of output. It is expected that automobile production double its current size and technological equipment, and the need for technological upgrading is great, the shift to trade with the west could accelerate faster.
and pharmaceutical exports to Europe to, which were worth $2.5 billion prior to 2012, will resume after sanctions are removed.

The intensification of sanction in 2012 exacerbated the already high unemployment situation in the labor market, now standing at 14%, but it affected females and males differently. Unemployment rates for women in particular increased, while for men remained flat. This divergence could be due to a variety of factors, including cohort effects that are different for men and women. The greater mobility of men versus women is likely to have played a key role. Sanctions caused closure of many jobs, but they also opened up opportunities in tradable sectors, to which men moved faster. Conversely, women were attracted to job opportunities in the services sector in part because of new technologies that are entering the market, creating jobs matching the skills of educated women more closely. Under the scenario of sanctions removal, and if it’s associated with exchange rate appreciation (See below) could lead to an expansion in the services sector. This could be disruptive for men who have greater dependency on tradable sectors, while women have been finding better job matches in the service sector. This could likely lead to a surge in female labor force participation as their job opportunities expand.

All these changes to the Iranian economy involve shifting resources from one use to another. The most significant aspect of sanctions relief is that it enables resources to be shifted to where they are more productive, that is, for the economy to produce more efficiently. For example, Iran can now produce and export those goods in which it has a comparative advantage, and import goods in which it does not. In short, sanctions relief can be thought of as an economic windfall to the Iranian economy.

The World Bank estimates the size of this windfall as a welfare gain of $13 billion or 2.8 percent of current welfare. Like all windfalls, however, they have to be properly managed in order that they sustainably benefit the population. In particular, as oil revenues enter the economy, the exchange rate will appreciate. While this will make imports cheaper, it will also make non-oil exports less competitive. During the early 2000s, when oil prices were soaring (and sanctions were not restrictive), Iran experienced this phenomenon. Many of the exporting industries suffered. In fact, the only ones that made progress were the petrochemicals and chemicals industries, which received massive subsidies, including subsidies on their consumption of fuel.

With the lifting of sanctions, the government of Iran has the opportunity to put in place a policy framework that will enable the economy to make optimal use of this windfall and put the economy on a path of sustained economic growth. This will require prioritizing good governance, transparency, public sector efficiency and effective anti-corruption measures to improve the competitiveness of its economy. The careful management of revenues through the wealth fund could even out oil highs and lows and protect future investment. Improving roads and telecommunications could boost high-tech exports and support the sort of innovation that rests on investing in human capital, making a lasting impact on Iran’s productivity in a post-oil era.

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