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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, foreign firms that transact business with entities designated by the United States for sanctions could face virtual exclusion from the U.S. economy.

The non-U.S. parties to the JCPOA—the United Kingdom (UK), 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 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 (IMF) 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. In October 2018, the IMF reduced its economic growth outlook for Iran, estimating a contraction of -3.6% in 2019, due primarily to the impact of U.S. sanctions.

Following adoption of the JCPOA, Iran’s crude exports had more than doubled, reaching a monthly peak of 2.5 million barrels per day (bpd) in early 2018, according to Bloomberg tanker tracking data. According to Bloomberg data, observed shipments fell below 1 million bpd as of January 2019; however, other estimates suggest Iranian trade remains higher. Reports of the Iranian oil tanker fleet switching off its transponders have made accurately tracking Iranian trade flows difficult.

Asia, Iran’s largest market, purchased more than 65% of Iran’s crude exports (**Figure 1**) in 2018; China was the

largest importer, accounting for more than one-third, 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.

Figure 1. Iran’s Crude Oil Exports by Region

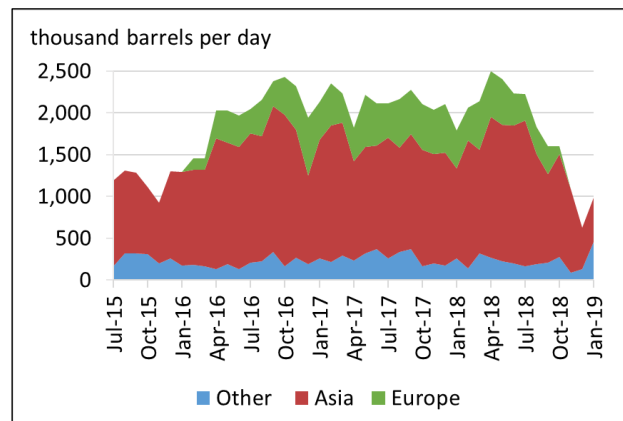
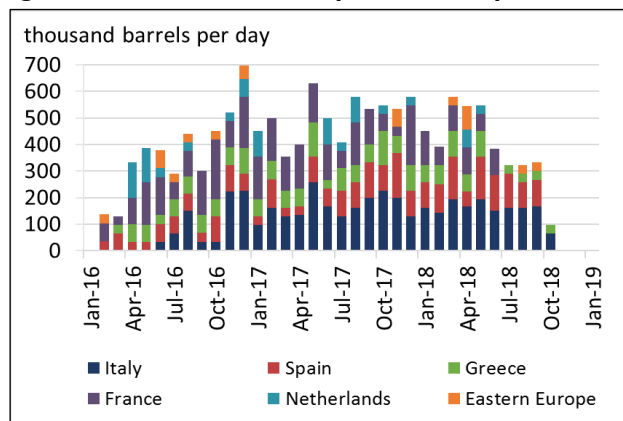


Figure 2. Iran’s Crude Oil Exports to Europe



Source: Bloomberg tanker tracking.

Iran’s continued adherence to the JCPOA might hinge on whether it can generate enough oil revenue to avoid a severe recession. 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, after U.S. sanctions were reimposed, EU imports fell to zero; other buyers, such as Japan and South Korea also cut purchases. Exceptions from U.S. sanctions allow certain countries to maintain limited trade, however (see below), and some purchases resumed in early 2019.

Since 2016, oil shipments to Europe had not surpassed pre-sanctions levels, unlike in China and India. By mid-2018, Iranian exports to China and India had grown significantly, with monthly purchases peaking near 800,000 bpd, as the countries stockpiled imports. In the wake of U.S. sanctions, both countries continued to buy Iranian oil, but at reduced volumes. Continued trade with China and India will be a major factor in Iran's ability to sustain oil export revenues.

After sanctions were eased in 2016, many EU and other foreign firms also 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, several firms pulled 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, the European Commission adopted an €18 million aid package for Iran in August 2018, which includes €8 million for Iran's private sector, such as support for “high-potential” Iranian SMEs. Further EU efforts may center on incentivizing EU small and medium-sized enterprises (SMEs), which generally have little or no exposure to the U.S. market, to expand business ties to 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. Nevertheless, the Trump Administration has refused to provide broad exemptions for EU firms to do business with Iran. The EU consequently developed a “Special Purpose Vehicle,” a mechanism that would allow EU firms to avoid U.S. sanctions by

conducting indirect, rather than direct, transactions with Iran. On January 31, 2019, France, Germany, and the UK registered the Instrument for Supporting Trade Exchanges (INSTEX), based in France. INSTEX will focus initially on facilitating trade in humanitarian sectors that generally are exempt from any sanctions but might eventually provide a platform to trade with Iran in oil and other products. However, U.S. sanctions penalize even indirect forms of trade with Iran. Moreover, INSTEX personnel and operations could be made subject to additional U.S. sanctions or sanctions designations. At a February 14, 2019 international conference in Warsaw, Poland, convened by the United States primarily to build greater international support for U.S. efforts to pressure Iran, Vice President Mike Pence stated “We call [the SPV] an effort to break American sanctions against Iran's murderous revolutionary regime. It's an ill-advised step that will only strengthen Iran, weaken the EU, and create still more distance between Europe and the United States.”

Another source of U.S.-EU friction is a U.S. insistence that the Brussels-based SWIFT electronic payments network expel Iranian banks from its system. The EU wanted Iran to remain within the network, but after many Iranian banks were again designated by the United States for sanctions, SWIFT disconnected those banks from the network.

At the same time, Europe's halting efforts to preserve the JCPOA have apparently emboldened Iran's hardliners. On February 26, 2019, Iran's Foreign Minister Mohammad Javad Zarif, chief negotiator of the JCPOA and recipient of hardliner criticism for arguing that Iran remain in it, announced his resignation. President Hassan Rouhani rejected the resignation.

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, and have indicated they will continue economic engagement with Iran. According to media reports, China and India have agreed not to purchase more than 360,000 bpd and 300,000 bpd of crude, respectively. While these are sizable reductions compared to import volumes in 2018 the two countries may help keep Iran's exports high enough to help the country avoid a more severe recession.

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 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 reportedly have 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 also have shifted to using Iran-operated tankers to deliver oil.

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