

The Economic Consequences of Détente With Iran, Huffington Post, Jul 15, 2015

This article, updated as of July 15, is up on Huffington Post: http://www.huffingtonpost.com/dr-nasser-h-saidi/the-economic-consequences_1_b_7802464.html

This is a momentous period for the Middle East: negotiations with Iran have concluded with a nuclear deal agreed after 20 months of laborious talks that ended a twelve year standoff. The interim nuclear agreement (Joint Plan of Action) with the P5+1 will now become a comprehensive nuclear agreement. After birth pangs remain: the US Congress has 60 days in which to consider the deal, though President Obama has stated that he would veto any attempt to block it; back in Iran, this agreement needs the backing and support of the supreme leader Ayatollah Ali Khamenei. This historic deal, to restrict Iran's nuclear program in exchange for relief from sanctions, will be a geo-political and economic game changer for the Gulf region.

The deal & negotiations focused on constraining Iran's nuclear capability. But what is at stake is Iran's regional role and importantly, this includes the economic consequences of détente. The biggest immediate benefit for Iran from an agreement is that the United States, EU and UN would lift their nuclear-related sanctions after a UN watchdog verifies that Iran has taken key steps in implementing the nuclear agreement. But policy makers should have a more comprehensive vision. The economic benefits from détente with Iran will accrue over the medium and longer term, with domestic and regional as well as global consequences. The stakes are much higher than a nuclear agreement. The opening of Iran and its regional and international integration can lead to higher economic growth, expansion of trade, increased investment and

job creation across the region with the potential to create a Gulf zone of security, peace and prosperity. Détente with Iran should be followed by entente on its geopolitical and regional role.

Iran détente: upsurge in growth, trade & investment

Iran is a large (1,648,195 sq.km), strategically located country, with a young population of about 80mn (similar to Egypt), an educated, productive labour force with high female labour force participation, and a diversified economy based on manufacturing, industry and agriculture. Iran has enormous oil & gas resources with 18.2% of the world's proved gas reserves (larger than Russia and Qatar) and 9.3% of oil reserves, and this despite the fact that no new wells have been drilled since 2007. Sanctions resulting in low international economic and financial integration and inward looking economic policies have generated growth below potential over an extended period of 25 years and an out-of-date infrastructure and capital stock. More recently, populist policies under Ahmadinejad and international banking and payments sanctions led to recession, fiscal deficits, inflation, deteriorating current account balances and declining international reserves. Reforms under Rouhani's leadership have stabilised the economy, lowered inflation, improved public finances but growth has been negatively impacted by lower oil prices.

Détente with Iran opens a massive trade & investment opportunity

A rapid, unequivocal removal of sanctions with Iran able to access and use its estimated US\$ 90 billion in foreign exchange reserves, would result in a strong recovery of trade, tourism, oil production & exports, boost private investment, lead to higher GDP growth, and set the basis for macroeconomic stability.

Iran is a gas and oil giant. Renewed investments in the energy

sector would not only mean increased exploration & drilling and new technology that would increase productivity, it would also change regional energy infrastructure. New and planned pipelines will link Iran to China, Asia, Pakistan and the Indian subcontinent. Iran's re-entry into the international oil and gas market will likely depress oil prices by \$5-\$10 with a reduction in the oil risk premium due to lower geopolitical risk from potential supply disruptions. Markets have already reacted with lower prices. Iran's large gas reserves would propel the country to become a major global player, especially given the recent G20 impetus to address climate change – implying a rapidly growing market for gas relative to oil. These changes would have spillover implications for the future of OPEC with an ascending Iran commanding a greater voice in OPEC's governance and decisions and impacting the global energy market.

Beyond the energy sector, the removal of sanctions can lead to a rapid resurgence of growth from a lackluster 3% in 2015-16 to 6%-8% in 2016-2018 driven by growth of trade, portfolio and direct investment -both domestic and foreign- including from the important Iranian diaspora with its substantial human capital, business and financial resources.

Sustained growth, regional and international integration, undoing the distortions resulting from sanctions to build a modern, knowledge-based, high-productivity growth economy will require structural reforms and high levels, 30%-40%, of investment relative to GDP. To modernise and rebuild the economy's capital stock, foreign investment and technology will be required. Conservatively, I estimate that Iran will require some US\$850 billion in total capital spending through 2020 and beyond, of which some US\$300-\$320 billion would be in foreign investment. The oil & gas sector alone will require some US\$250-\$300 billion, with infrastructure, transport (including cars and planes) and logistics, services, tourism & hospitality and retail being major areas. Oil & gas will be

the immediate priority and Iran has developed a modern template for new international oil contracts that is intended to attract international oil companies, including from the US, Europe and China. Iran's oil & gas reserves are an unprecedented opportunity.

Post-sanctions Iran requires domestic reforms as well as foreign capital & technology

Does Iran have the absorptive capacity to efficiently benefit from the high levels of investment required and can it develop an enabling framework to attract investors? Sanctions removal will not be a panacea. Economic and financial reforms will be critical to enable growth and undo a legacy of inward-oriented economic development. To open up the substantial trade, investment and growth opportunities and fully benefit from sanctions removal, Iran needs to achieve macroeconomic stability; undertake structural, legal and regulatory reforms to ease the cost of doing business and improve the investment climate & investor protection; commit to market-based reforms alongside greater international openness; reduce and target subsidies, in addition to developing a new industrial policy; liberalize economic activity, with an expanded role for the private sector and a diminution of the role of state owned and government related enterprises along with banking sector liberalisation, and a gradual unification of exchange rates and removal of exchange controls. This comprehensive reform platform will require domestic political consensus built on the promise of an upsurge in growth and job creation. This will be massive political undertaking likely to be extended over the coming decade.

Gulf region can boom with Iran detente

The GCC countries along with Iraq and Lebanon will be major beneficiaries of a post-sanctions Iran. The immediate benefit would come from a revival of trade, with the UAE, Oman being major beneficiaries as trade conduits and entrepôts, along

with major trade partners including China and the EU. The UAE and Dubai as a regional business, trade and financial hub with an active Iranian diaspora and Lebanon's banking system stand to gain from Iran's opening. The capital rich GCC countries would benefit from high return investment opportunities, while their construction and real estate development companies with their expertise and experience can participate in infrastructure and development projects. Détente with Iran would also mean lower sovereign risk premia resulting in a lower cost of capital and credit for companies operating in the Gulf. Détente could mean an unprecedented boom for the Gulf. The opportunity is there. Will the political will and vision be there to transform the opportunity into reality?

A Fork in the Road: Peace & Prosperity or Destructive Arms Race?

We are at a turning point, a junction with two paths. Which path is chosen will depend on which vision prevails, on strategic choices and politics. One path is a pessimistic scenario of heightened distrust, polarisation and extremism, resulting in regional fragmentation and an arms race. Under this scenario, not only would geopolitical tensions remain, they would be exacerbated by the growing Sunni-Shia schism, therefore leading to an arms race. This would be a loss-loss situation, especially given that arms expenditures are not linked to local industry or to the economies of the region. An arms race would only result in imports and leakages to the rest of the world without any direct economic benefit to the Gulf countries, indeed resulting in a diversion of resources away from urgently needed infrastructure and social capital investments to address the current demise of the Arab firestorm.

The other path leads towards greater economic and financial integration of the Gulf region. Détente with Iran and a Saudi/GCC-Iranian entente would be key to the fight against extremism, Daesh and stabilization in many countries of the

region. In turn, a Saudi/GCC-Iran entente would open the door to the reconstruction of Iraq, Lebanon, Syria, and Yemen, implying some US\$1 trillion in infrastructure and reconstruction projects for those countries. In total, including Iran, we could foresee a massive \$1.8 trillion in investment over the coming decade, which would be 'growth lifting' and create jobs across the region, the overarching policy priority. The plentiful capital resources of private investors and sovereign wealth funds of the region would be directed towards economic development & reconstruction rather than, as is currently the case, in sterile low yielding foreign investments. The huge investment programme would also be instrumental in developing regional capital markets which can be tapped for longer-term development and reconstruction projects.

Détente & Entente: Frameworks for Cooperation

Moving forward requires putting in place a framework for cooperation. Three major new policy instruments should be put in place to implement the vision outlined above: (a) A "GCC 6+2" (i.e. including Iraq and Iran) institutional cooperation framework: an official platform for dialogue, consultation & open negotiations on a wide set of regional issues including security, economic and financial relations; (b) a regional FTA including the GCC, Iran, Iraq, Jordan, and Egypt creating a market of 2.5bn people with GDP of \$3 trillion; (c) An Arab Bank for Reconstruction and Development to finance infrastructure, reconstruction and regional projects. In this optimistic but feasible scenario, the Gulf would become a zone of peace, security & prosperity. This would be an ambitious outcome whereby Iranian-Saudi cooperation would be similar to Franco-German cooperation post-WW II! The bottom line is to use détente with Iran to create a zone of peace and prosperity for all in the Gulf based on tangible economic opportunities and benefits for all countries. That is the vision of hope for our young people that should be put up to fight Daesh and

extremism.