Economic consequences of détente with Iran

Improved relations with Iran would be good for the region – writes Dr Nasser Saidi

This is a momentous period for the Middle East. By the time this article is published, negotiations with Iran will have reached a turning point. A nuclear deal is imminent. The interim nuclear agreement with the five permanent members of the United Nations Security Council and Germany – in effect since January 20, 2014, and extended to June 30, 2015, – will become a comprehensive nuclear agreement. There are obstacles. United States President Barack Obama faces an uphill battle convincing Congress and various US allies (Israel and Saudi), while the European Union nations remain tough on conditionality. Nonetheless, a historic deal to restrict Iran's nuclear programme in exchange for relief from sanctions would be a geopolitical and economic game changer for the Gulf region.

Negotiations have mainly focused on Iran's nuclear capability. But what is at stake is Iran's regional role and this should include the economic consequences of détente. The biggest immediate benefit for Iran from an agreement is that the US, EU and United Nations would lift their nuclear-related sanctions after a UN watchdog verifies that Iran has taken key steps in implementing the nuclear agreement. But policymakers 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.

Iran détente: upsurge in growth, trade and investment

Iran is a large, strategically located country with a population of about 80m (similar to Egypt), an educated labour force and diversified economy. Iran also has enormous resources with 18.2 per cent of the world's proven gas reserves (larger than Russia and Qatar) and 9.3 per cent of oil reserves. 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. More recently, populist policies under former president Mahmoud Ahmadinejad and international banking – and payments – sanctions resulted in recession, fiscal deficits, inflation, retrenched current account balances and lower international reserves. Reforms under current President Rouhani's leadership have stabilised the economy, lowered inflation and improved public finances but growth has been negatively impacted by low oil prices.

A massive trade and investment opportunity

A rapid, unequivocal removal of sanctions with Iran able to access and use its estimated $90bn in foreign exchange reserves would result in the strong recovery of trade, tourism, oil production and exports. It would also boost private investment, lead to higher gross domestic product growth and set the basis for macroeconomic stability.

We know Iran is a gas and oil giant. Renewed investments in the energy sector would not only mean increased exploration and new technology that would increase productivity. It would also change regional energy infrastructure. Iran's re-entry into the international oil and gas market will likely depress oil prices by $5 to $10 with a reduction in the oil risk premium. Iran's large gas reserves would propel the country to become a major global player, especially given the recent Group of 20 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 the Organisation of Petroleum Exporting Countries and the global energy market.

Beyond the energy sector, the removal of sanctions can lead to a rapid resurgence of growth. From a lacklustre 3 per cent in 2015 to 2016, to 6 to 8 per cent in 2016 to 2018 – driven by trade, portfolio and direct investment, both domestic and foreign.

Sustained growth, international integration and undoing the distortions resulting from sanctions to build a modern, knowledge-based, high-productivity growth economy will require structural reforms. Iran will also need high levels (30 per cent-40 per cent) of investment relative to GDP. Conservatively, Iran will require $850bn in total capital spending through to 2020, of which some $300-$320bn would be in foreign investment. The oil sector alone will require some $250-300bn with infrastructure, transport, logistics, services, tourism and hospitality, and retail, being major areas.

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

Sanction 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. This means undertaking structural, legal and regulatory reforms to ease the cost of doing business and improve the investment climate and investor protection. Tehran will need to commit to market-based reforms alongside greater international openness. The reduction and targeting of subsidies will be required, in addition to developing a new industrial policy and liberalising economic activity. An expanded role for the private sector and a diminution of the role of state owned and government related enterprises will be necessary. This comprehensive reform platform will require domestic political consensus built on the promise of an upsurge in growth and job creation.

The Gulf can boom with Iran detente

The Gulf Cooperation Council 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 United Arab Emirates and Oman being major beneficiaries, 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 can participate in infrastructure and development projects. Détente with Iran would also mean lower sovereign risk premium resulting in a lower cost of capital for companies operating in the Gulf. Détente could mean an unprecedented boom for the region.

Peace and 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 growing distrust and extremism, 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.

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 and stabilisation in many regional countries. In turn, a Saudi/GCC-Iran entente would open the door to the reconstruction of Iraq, Lebanon, Syria and Yemen – implying some $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. It would be 'growth lifting' and create jobs across the region, the overarching policy priority. The huge investment programme would also be instrumental in developing regional capital markets that can be tapped for longer term development and reconstruction projects.

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Détente and entente: frameworks for cooperation

Three major new policy instruments should be put in place to implement the vision outlined above. First a GCC 6+2 (including Iraq and Iran) institutional cooperation framework: an official platform for dialogue, consultation and open negotiations on a wide set of regional issues including security, economic and financial relations. Second a regional free trade agreement including the GCC, Iran, Iraq, Jordan, and Egypt creating a market of 2.5bn people with GDP of $3 trillion. And finally 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 and prosperity. This would be an ambitious outcome whereby Iranian-Saudi cooperation would be similar to Franco-German cooperation after the Second World War. 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.

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