Highlights: Economic Implications of Lifting Sanctions on Iran

Normally a quiet month before the August break, 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 nuclear agreement on July 14, 2015, leading to the lifting of international sanctions on Iran (Box 1). 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 most significant change will be Iran’s return to the oil market. The World Bank estimates that the eventual addition of one million barrels a day (mb/d) from Iran, assuming no strategic response from other oil exporters, would lower oil prices by 14 percent or $10 per barrel in 2016. Oil importers, including the European Union (EU) and United States (US), will gain while oil exporters, especially the Gulf countries, will lose.

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. The World Bank estimates that sanctions reduced Iranian exports by $17.1 billion during 2012-14, equivalent to 13.5 percent of total exports in that period and about 4.5 percent of 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.

Thirdly, 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—expansion in trade and lower trade costs. In addition, there are estimates that Iran holds about $100 billion worth of frozen assets overseas (including investment in oil projects overseas) of which $29 billion in Central Bank’s assets and oil revenues will be released immediately after sanctions removal. Finally, 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.

In addition to slowing down, the Iranian economy underwent a structural shift during the sanctions era, with the oil, automobile, technology and arms, construction and financial sectors
declining the most. As sanctions are lifted, these sectors are likely to see an expansion of output.

All these changes to the 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 that fetch the highest prices in world markets, and buy imports that have the lowest prices. 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 maximum use of this windfall and put the economy on a path of sustained economic growth.