
Trump scuttles the Iran nuclear deal (& the Middle East)

Mushtaq Khan, May 14, 2018

It was anticipated, but is still unsettling. The global media is broadly consistent in its view: Iran has been in compliance; the European partners (the UK, France and Germany) have been trying to dissuade President Trump from taking this step; China has been silent so far; the decision could undermine the summit meeting between the US and North Korea scheduled for June 12, 2018; and President Trump's new foreign policy team is far more hawkish towards Iran.

President Trump's justification for scuttling the Iran nuclear deal has fueled global anxiety. The White House seeks to expand the coverage of the nuclear deal, to include Iran's ballistic missile program and contain its regional influence. Trump has threatened tough US sanctions against any commercial /financial institutions that have direct dealings with Iran, and secondary sanctions against indirect partners. While US sanctions will take time to be enforced, just the threat will do sufficient damage.

As discussed later, the commercial interests of the signatories of the Joint Comprehensive Plan of Action (JCPOA), are the primary reason for the muted response of European leaders. President Macron has talked about the need for a broader agreement with Iran, effectively agreeing with President Trump's desire for a more comprehensive understanding of the deal with Iran. The point of contention between Trump and Macron, is that the current deal should stay in place till a better deal is agreed upon.

Will it work?

This is wishful thinking, as the key premise of the 2015 agreement was that Iran would roll-back its nuclear program in exchange for the lifting of economic sanctions. Unilaterally throwing out the entire agreement, and insisting that Iran must concede more for the same reward, defies logic. In our view, this is a US tactic to threaten Iranians with dire economic consequences, which has already triggered a currency crisis in Iran – this builds further pressure on a financial system where banks are already stressed with non-performing loans and corruption. Perhaps the thinking is that unlike Obama's effort to contain Iran, Trump's threat to totally isolate Iran (with possible military consequences) could break the will of the Iranians, which in turn could trigger regime change in Iran.

We would argue that Trump's decision is not about forcing Iran to do more, but to create an environment whereby both sides cannot step back. While this may appear irrational, as it is a sure recipe for further destabilization in the Middle East (and possibly a regional war), one must realize that all regional players (Iran, Saudi Arabia and Israel) are either facing an existential threat, or are developing a national narrative that the region has reached a point of no return.

Historical context

Iran has gained regional influence in Iraq after the failed US invasion in 2003. Its influence now extends into Lebanon, Yemen, Syria and Afghanistan. Iran also has the implicit support of Russia (in Syria) and Turkey (in handling the Kurdish threat), and has secured a land route via Syria to both Israel and Lebanon. It has managed to consolidate this influence despite UN and US sanctions, which means it has the ability to withstand global pressure while it promotes its regional ambitions.

Israel has been clamoring about the Iranian threat for many years now, but under President Obama these warnings gained little traction in the White House. America's non-policy regarding the Syrian civil war

further alienated Israel, which perhaps realized that its only option is to get closer to Arab states that also feel threatened by Iran. While Saudi Arabia and the UAE are clear in their anti-Iran stance, Qatar is not, and Oman and Kuwait chose to remain neutral.

Saudi decided to launch its military campaign against Yemen in March 2015, despite Obama's ambivalence. This signaled that Saudi Arabia felt strongly enough to take this initiative even without the US. Around this time, the Syrian conflict saw the active participation of Russian ground forces, which aligned themselves with the regime of Bashir al-Assad. In collaboration with Iranian-trained militias, this helped the Syrian government defeat ISIS. As ISIS was being defeated, Israel realized that Iran's influence in Syria would grow overtime (as it has in Iraq), which could threaten Israel's national security. This explains Prime Minister Netanyahu's jubilation at Candidate Trump's victory in November 2016, when the rest of the world was still reeling from the shock.

After the elections, both Saudi Arabia and Israel moved aggressively to lock-in President Trump's support, since his campaign promises included the need to shift the US Embassy to Jerusalem, and the need to scrap the Iran nuclear deal, which he characterized as the worst deal the US government had ever made. Within one week the gauntlet was thrown: President Trump announced his decision to exit the Iran nuclear deal, and the US government opened its new Embassy in Jerusalem.

Since Arab support for the Palestinian cause has waned in recent years, Iran now appears to be the sole bearer of Palestinian aspirations, and has earned the wrath of the US, Israel and Saudi Arabia. With the deepening fissures in the Middle East, the steps taken by President Trump could redraw the map of the Middle East.

What could happen next?

Many commentators have said that the demise of the Iran nuclear deal would incentivize it to resume its nuclear program. On the back of the diplomatic breakthrough between the US and North Korea, Iran's leadership may assume that its ability to bargain directly with the US – and do so from a position of strength – would be enhanced if Iran had nuclear weapons that could be reliably delivered.

From the US perspective, the decision to restart the nuclear program would isolate Iran from the European partners of JCPOA (and most likely China), and create a global coalition that could eventually topple the Iranian government. At least that is the thinking in Israel and Saudi Arabia, and also of John Bolton, who is the newly minted US National Security Adviser. Bolton is cast from the same mold that gave us the discredited neocons who pushed for the 2003 Iraq war. As most will now agree, this created the groundwork for the current turmoil in the Middle East.

For seasoned strategists like the Iranians, this end game should be clear enough. From Iran's perspective, a superior strategy would be to engage the other members of the JCPOA and ask for guidance, effectively shaming them to take a stance against American unilateralism.

In the 21st century, clashing geo-political agendas will not be settled militarily – it's more about the economics, as this impacts a much larger group of stakeholders, and does so at a very personal level. A case in point is Europe's inability to stand up to President Trump: the threat to European companies (and financial institutions) from US sanctions is the decisive factor. As argued in an earlier paper (*A Self Induced Challenge to the US Dollar*, October 13, 2017), the dominance of the US Dollar in global trade and investment flows, creates economic vulnerability for trading countries that use the Dollar. If this vulnerability is fully exploited, it could result in the same pain and suffering experienced in a destructive war.

In some ways, European politicians are more constrained by their commercial enterprises than their political compulsions. The short-term disruption to commercial operations and planning, even if these companies – especially banks – *feel* they could be targeted by secondary sanctions, is sufficient to shun Iran. Since the US is a global economic powerhouse, and most companies/banks have a global reach, they are particularly vulnerable. In our view, it is not the actual sanctions *per se*, but the risk of being linked to a third-party that interacts with Iran – the threat is almost subjective.

Profit-driven companies are not likely to take such risks, even if European governments assure their companies that exemptions (on their behalf) will be negotiated directly with the US government. In our view, the US may be willing to provide such exemptions, but this will only keep European companies on a tight leash. In effect, the US could withdraw exemptions at will, which means the US is willing to use its enormous commercial clout to pursue its foreign policy objectives.

How will Iran react?

The western media is worried that Iran could be a wild card: more simply, Iran could react erratically, and push the region into war. We do not see Iran being irrational or preemptive, and is unlikely to restart its nuclear program as this undermines its diplomatic high ground. As of now, Iran's focus is to reach out to Russia and China (both are signatories of the JCPOA) to help convince the European partners to stand by the nuclear deal.¹ Even if this does not sway the European partners (global media is now talking openly of the vulnerability of European companies), it does expose the rift within the JCPOA.²

Iran's global isolation has hampered its economic development. The people's aspiration to rejoin the global economy has largely been quashed, media channels are tracking the solemn mood on the Iranian streets. While the US and its regional allies are counting on this public anger at being isolated again as sufficient impetus for a revolt against the Iranian regime, a new phase of isolation is more likely to create a hardline Iranian government.

This government will shape public anxiety into nationalistic fervor against the US, Israel and Saudi Arabia – it will lionize Russia and China, and flag the compromised Europe, to show that the tide is turning against the US. It will urge Iranians to stand firm, with the end goal to ensure that the US military presence in the Middle East is removed for good.

While the Europeans are unlikely to give Iran a lifeline, China, Russia and perhaps India could be more sympathetic. As discussed in our October 2017 paper, China is best placed to create a trade-finance infrastructure that is totally immune to US sanctions. This would take time, which means that US sanctions would hurt the Iranian people. Having said this, Iran will not just adopt a defensive posture to protect itself – it is more likely to use its regional network to challenge US allies in the Middle East.³

¹ Both Russia and China are likely to argue that if Iran is cornered and made to lose face, it will step away. This would surely destabilize the Middle East, which is already facing seriously challenges in Syria and Yemen. After the experience in Iraq, both Russia and China are likely to be quite firm in their views about US unilateral actions.

² This indicates that members of the JCPOA may be working at cross purposes. The Trump administration has stated that it is in the interests of the Europeans to follow the US lead to force Iran to return to the negotiation table for a more comprehensive agreement. They have hinted that secondary sanctions could be imposed on companies that continue to work with Iran. Russia and China are unlikely to endorse this step, while the Europeans would like to remain neutral if they had a choice. So the next steps for the JCPOA are very unclear. In our view, this stalemate could easily have been predicted, which suggests that a more comprehensive nuclear agreement with Iran is only a pipedream.

³ With several decades of involvement in Iraq, Lebanon, Syria, Yemen, Bahrain and Afghanistan – and an enduring enmity with Saudi Arabia – Iran may stir up trouble in the region. An argument could be made that political instability, or a power vacuum, creates space for external influence. As happened in Iraq, the changing US strategy after the 2003 invasion and Obama's stated goal to end its military presence in Iraq, allowed Iran to create a grass root presence in the country.

From Iran's perspective, if it can manage the adverse impact of the US sanctions, time will work against the US and its regional allies. During this period, Iran could target countries like Bahrain, Saudi Arabia and the UAE, and fortify its presence in Iraq, Syria and Lebanon. In our view, the stakes for both sides are now too high for either side to back down.

The real fear is how the confrontation between Iran and Israel could escalate. Iran and Russia have a common goal to safeguard the Assad regime in Syria, and have an agreement with Turkey to find a peaceful solution to the Syrian civil war. If Russia somehow gets involved in the skirmishes between Iran and Israel, it is likely to side with Iran (an enemy's enemy, is your friend). This means the region could see *another* proxy war in Syria, in addition to the Saudi-Iran standoff in Yemen.⁴

Outlook for oil prices

The prelude to Trump's decision to scrap the Iran nuclear deal, witnessed a sympathetic increase in oil prices by \$ 10/b. Analysts feel that oil prices could increase further if Iran retaliates. While we agree that the sharp increase in oil prices reflects the growing uncertainty in the region, we do not share the view that Iran would *intentionally* take any step that increases oil prices. The reason is simple: rising oil prices will help Saudi Arabia (and its Arab allies) far more than it would help Iran. By most accounts, the economic sanctions promised by President Trump, will reduce Iran's oil exports, but higher prices will increase the valuation of the Saudi giant Aramco.

In overall terms, we feel the market dynamics that kept oil prices range-bound over the past four years (i.e., non-OPEC production, specifically North American shale), will push down oil prices once the uncertainty in the Middle East eases. Scenarios that entail the mining or blocking of the Straits of Hormuz, are simply fanciful.

In our view, the Brent benchmark would again settle around \$ 70/b.

Impact on Pakistan

A flare up in the Middle East between Iran and Saudi Arabia, with Israel taking sides, will impact the entire region. In the case of Pakistan, there are several areas that need to be watched: (1) uncertainty could further spike oil prices, which will hurt Pakistan's BoP; (2) if the relationship between Iran and the US worsens, this could manifest itself in Afghanistan; (3) Pakistan's neutrality in the Iran-Saudi standoff, could hurt our relationship with the Kingdom; and (4) secondary sanctions against Chinese companies could undermine CPEC, or impact Pakistani entities that are involved in the project.

We will simply list our assessment:

1. As stated earlier, even if oil prices increase further, the fundamentals of the oil market should ensure that prices fall and settle around \$ 70/b. However, given Pakistan's acute BoP problem, retail fuel prices would have to rise to reduce the country's oil bill. So while elevated global prices could justify increasing retail fuel prices in the country, even in the absence of a sharp increase in oil prices, Pakistan would have to proceed as if there *has* been a negative oil shock.
2. If strained relations between the US and Iran filter down into Afghanistan, Pakistan will have to deal with the repercussions. There is a distinct possibility that Afghanistan's instability could seep into Pakistan. If the US were to blame us more directly, it would undermine our relationship with the US, which in turn could undermine confidence in the Pakistan economy.

⁴ President Trump's disdain for multilateral organizations is particularly disconcerting, as the showdown has pitched it against both Russia and China. So the question is how regional conflicts are to be resolved when the avenue of mediation is dysfunctional.

3. If the Iran-Saudi standoff becomes more acrimonious, the Saudis may expect Pakistan to side with them. This would go against the principled stand taken earlier when Saudi Arabia asked Pakistan to join its coalition in Yemen. However, if tensions in the Middle East worsen and Pakistan is again asked – and again refuses – this could hurt our relationship with the Kingdom. This could have adverse repercussions for inward remittances, as the two largest sources of worker remittances into Pakistan are from Saudi Arabia and the UAE. And,
4. If the economic antagonism between China and the US were to escalate, some commentators have said this could adversely impact CPEC. While we do not see a direct link between the troubles in the Middle East and CPEC, we have talked about how the entire CPEC project needs to be rethought to make it commercially successful (*Pakistan's Balance of Payments, the IMF & China*, September 14, 2017).

Since Pakistan's economy needs tough policy measures to stabilize, and relations with the US are already strained, a military flare up in the Middle East is not as dire for Pakistan as it could be for the region. Furthermore, there is little that Pakistan can do to influence the standoff between Iran and Saudi Arabia. All that Pakistan can do, is watch and hope for the best.

Conclusion

The events of the past week could be the tipping point for the Middle East. Simmering differences have been sparked by President Trump, and perhaps it is no longer possible to return to the status quo. The US cannot play a mediating role in the region, which means others will have to step up. Europe would be the ideal candidate, but its economic vulnerability to US sanctions, compromises its ability to be an objective adjudicator. Unfortunately, this impasse does not lend to an easy solution.

If one looks closely at the political rhetoric coming out of Israel, Saudi Arabia, Iran and the US over the past several years, President Trump's decision to quit the Iran nuclear deal, is not terribly surprising. There are perceived existential threats facing regional players in the Middle East, which would be easier to navigate if the US played its traditional role in global affairs. Since the US is as explicitly partisan as the others in the region, the current tensions in the Middle East could flare up without a credible avenue to mediate the differences.

To better appreciate the uncertainty (and gravity) of the situation in the Middle East, one can draw a comparison with the Korean peninsula – both focus on a nuclear “understanding” and involve the world's military and economic powers. However, in the case of the Koreas, the two countries are seeking a formal peace treaty, and if they were left to themselves, a formal end of the Korean War is almost certain. Trade and people-to-people travel in the Korean peninsula would be welcomed by most, if not all Koreans. In our view, the real complication is the goals/interests of the Cold War antagonists (China and the US) – these must either be addressed, or simply laid to rest.

In the Middle East however, the big-picture antagonists (China, Russia and the US) are only more civil to each other, compared to the proxies on the ground (Israel, Saudi Arabia and Iran). So while we feel more comfortable predicting a good outcome in Korea, we cannot say the same for the Middle East. It's just wait and see.