

## ISSUE BRIEF

# Post-Sanctions Economic Opportunities and Risks in Iran

FEBRUARY 2016 ROBERT D. HORMATS

On January 16, 2016, the International Atomic Energy Agency (IAEA) verified that Iran had implemented key measures under the Joint Comprehensive Plan of Action (JCPOA). As a result, nuclear-related sanctions previously imposed by the United Nations, the European Union, and the United States were lifted. The removal of these sanctions opens up a wide range of possibilities for investment in and trade with Iran.

There is optimism in many quarters of Iran and among foreign businesses that sanctions relief will sweep away Iran's now considerable economic problems and lead to profitable investment opportunities. However, this optimism needs to be tempered by the realization that deeper economic, financial, and business challenges must be successfully addressed to produce favorable long-term outcomes for foreign investors and Iranians.

The **Atlantic Council's Future of Iran Initiative** aims to be the most comprehensive source of forward-looking analysis on Iran and on the opportunities and risks posed by an Iran freed from economic sanctions and more integrated into the international community. The initiative provides a political safe space in which both the most skeptical critics and the most optimistic assessors of Iran's ambitions can build a consensus within the United States, and a path forward in strengthening regional and global security and prosperity.

Implementation of the JCPOA certainly will give a lift to Iran's economy, permitting the country access to Iranian funds that had been blocked abroad under sanctions, additional oil exports, and more trade and investment. However, sustained and comprehensive improvements are likely to depend on Iran's leaders making difficult, and in some cases politically risky, decisions to reform key elements of the economy, enhance transparency, strengthen the country's financial institutions, improve the environment for private investment, and provide for the inclusion of larger numbers of Iranians in the nation's future growth. Iran's leaders will have to decide, among other things, the degree to which they can or will reduce the enormous influence of clerical and military interests in the economy. They also will have to determine just how far to go in allowing increased foreign investment, especially when it could threaten the influence of such interests.

Proposals for reform and the potential for additional Western, particularly American, investment already have triggered debates among top leaders.

At Friday prayers several months ago (according to an American scholar there at the time), Iran's Supreme Leader Ayatollah Ali Khamenei forcefully voiced his opposition to investment from the US, arguing that it would threaten Iran's Islamic system. The following day, President Hassan Rouhani, having just returned from New York (where he addressed the United Nations and met with groups of US business leaders) asserted that he had reassured potential American investors that they would be welcome in Iran.<sup>1</sup>

In addition to the mixed signals from Iran's leadership, potential foreign investors face a formidable set of issues. They will have to make difficult decisions regarding the kinds of businesses they invest in, the risks they will take, and the partners with whom they will work. Many will find significant business opportunities in Iran given the country's economic strengths, especially the formidable talents of its people and the broad diversity of its economy, as well as its enormous energy resources. Determining how best to pursue these opportunities, however, will require understanding, in considerable depth, the country's unique and complex political, historic, economic, and social circumstances. Investors will need to be aware of the potential ramifications their commercial activities in Iran may have on their relationships with other countries, in light of highly charged geopolitical issues in the region, ongoing human rights concerns, and security-related differences between Iran and the United States. They should also fully understand the details of US sanctions that will remain in effect after implementation of the JCPOA.

### New Treasury Guidelines

On Implementation Day, the Treasury Department's Office of Foreign Assets Control (OFAC) released guidelines on the status of sanctions going forward. These eliminate most "secondary" sanctions, i.e. sanctions that penalize foreign businesses and

individuals for investing in or trading with Iran.<sup>2</sup> This action will permit them to deal with entities in Iran's financial, banking, energy, petrochemical, shipping, shipbuilding, and automotive sectors. However, except in certain limited cases (discussed below) the guidelines do not lift "primary" sanctions, i.e. those that restrict American individuals and companies from doing business in Iran.

As agreed to in the JCPOA, the United States did lift some primary sanctions—notably on the export and sale of passenger aircraft, related parts, and services provided they were only used for civil and commercial purposes. (Firms that sell humanitarian goods, including food, medicine, medical devices, and some types of communications equipment have never been subject to sanctions; however, they have had difficulty arranging for payments due to sanctions that restrict banking and dollar transactions.) The guidelines also permit the resumption of imports of Iranian-origin carpets and foodstuffs (including pistachio nuts and caviar).

Regarding the matter of foreign subsidiaries of US companies, OFAC going forward will provide licenses to "non-U.S. entities that are owned or controlled by a U.S. person to engage in activities that are consistent with the JCPOA and applicable U.S. laws and regulations."<sup>3</sup> Importantly, the subsidiaries must establish a firewall between their own operations and US entities and persons. Although the general license allowing US subsidiaries to do business in Iran is broadly constructed, how the license is construed in practice, i.e. how separate the subsidiary must actually be from the parent, will have a huge impact on the future trade and investment of individual subsidiaries vis-à-vis Iran and on Iranian business relationships with them.

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and social  
circumstances.

1 "Rouhani: US firms can invest in post-sanctions Iran," *Iran Daily*, September 26, 2015, [www.iran-daily.com/News/127661.html](http://www.iran-daily.com/News/127661.html).

2 "Guidance Relating to the Lifting of Certain Sanctions Pursuant to the Joint Comprehensive Plan of Action on Implementation Day," US Department of the Treasury, January 16, 2016, [https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/Implement\\_guide\\_jcpoa.pdf](https://www.treasury.gov/resourcecenter/sanctions/Programs/Documents/Implement_guide_jcpoa.pdf).

3 Ibid, pp. 2-3



The OFAC document also emphasizes how limited the lifting of sanctions will be with respect to American companies, noting that with the exception of the categories described above, “none of the sanctions-related commitments outlined in this guidance shall apply to U.S. persons, including U.S. companies, [which] continue to be broadly prohibited from engaging in transactions or dealings with Iran and the Government of Iran unless such activities are exempt from regulation or authorized by OFAC.”<sup>4</sup> American sanctions on Iran that relate to other targets, such as terrorism, human rights issues, or ballistic missile tests will continue.

OFAC further highlights that even in cases where secondary sanctions are removed, this action does not apply “to transactions that involve persons who remain or are placed on the SDN list.”<sup>5</sup> This is the

list of Specially Designated Nationals and Blocked Persons (OFAC’s “restricted list”) that, in the Iran context, includes individuals and entities deemed by the US Government to be in violation of Congressional legislation or executive branch findings related to human rights abuses, support for terrorist groups, or certain Iranian military actions abroad. In connection with Implementation Day, OFAC did, however, remove more than four hundred Iranian individuals and entities from the SDN list, leaving about two hundred still so designated.

A number of sanctions that relate to the use of US banks for clearance of financial transactions will also continue. However there are limited exceptions. After Implementation Day, if a US company is operating under an OFAC license, the license also authorizes all transactions “ordinarily incident to a licensed transaction and necessary to give effect thereto.”<sup>6</sup>

4 Ibid.

5 Ibid, p. 4.

6 “Frequently Asked Questions Relating to the Lifting of Certain



This includes payments, meaning that US banks are authorized to transfer funds to and from Iran for a licensed transaction. But the general license for foreign subsidiaries to do business with Iran issued on January 16 explicitly excludes the transfer of funds to or from a US bank or dealer. Accordingly, foreign subsidiaries of US parents cannot use American banks for their business in Iran. Other foreign companies also cannot route transactions involving Iran through a US bank and indeed could be subject to penalties for “causing” a violation by the US bank. For example, European companies that seek to do business in Iran will need to use clearance systems other than those involving US banks, in order to avoid running afoul of US sanctions. The practical effect of the prohibition on the use of US banks for clearing transactions for business with Iran is that US subsidiaries and foreign companies (and, of course, US companies unless they have a special license) will be unable to engage in dollar transactions with Iran.

### Conditions in Iran Influencing Future Investment

Any analysis of Iran’s investment potential must take into account that Iran’s greatest economic strength is its people. The country has a skilled workforce and an extraordinarily high literacy rate of over 87 percent. Iranians have particular skills in mathematics, science, information technology, engineering, and medicine. Nearly half of all college graduates major in these fields; this far exceeds the figure in any other Middle Eastern nation. Roughly 70 percent of Iran’s science and engineering students are women.

Potential investors will also be impressed by the youth of Iran: Two thirds of Iranians are under thirty-five. The literacy rate for those in the fifteen to twenty-five age bracket is nearly 100 percent. Most are impressively computer savvy. More than 40 percent of Iran’s population uses the Internet (for its neighbor Iraq, the figure is only 10 percent), and smart phones are ubiquitous.

Young Iranians also harbor an intense desire to be part of the world again, having been largely isolated from contact with their contemporaries in the United States and Europe. In the 1970s, when I visited Iran

several times as a US Government official, there were a multitude of contacts with the United States and other Western nations; fifty thousand Americans were then living and working in Iran and there were significant levels of tourism travel and student exchanges.

In addition, young Iranians are greatly interested in American culture, entrepreneurialism, and innovation. The vast majority welcome the nuclear deal because they hope it will lead to an opening to the West—and particularly to the United States—enabling more contacts and travel. Many also recognize that additional foreign investment will provide a substantial increase in employment opportunities.

Potential investors will find a highly diversified economy: While oil and gas continue to be the major components of Iran’s economy, there is also a highly developed services sector. This includes a significant (if troubled) banking industry and an appreciable telecommunications infrastructure. In addition, the country has a large manufacturing sector, which produces autos, busses, petrochemicals, and pharmaceuticals, as well as steel and other metals; and Iran has highly dynamic and successful expatriate communities that can facilitate trade and investment relationships with such companies.

Iranian entrepreneurs and engineers, along with the businesses they have created, will provide a range of opportunities for foreign companies looking to establish partnerships. Years of sanctions have forced Iranians to create their own Internet companies and services—and provided an incentive to establish a wide variety of homegrown information technology firms. Additionally, there is a highly developed tourist sector, already gearing up to accommodate large numbers of visitors planning to see the country’s spectacular ancient sites.

Those contemplating portfolio investments will find a modern stock exchange in Tehran, with on-line trading and a market capitalization of roughly \$90 billion (the fifth largest in the Middle East). Potential investors should be aware, however, that a significant number of companies listed on the stock exchange are also among the roughly 200 entities remaining on the SDN List.<sup>7</sup> Iran also runs an Oil Bourse, a Foreign Exchange Bourse, and an Energy/Electricity Bourse.

U.S. Sanctions Under the Joint Comprehensive Plan of Action (JCPOA) on Implementation Day,” US Department of the Treasury, January 16, 2016, p. 25, [https://www.treasury.gov/resource-center/sanctions/Programs/Documents/jcpoa\\_faqs.pdf](https://www.treasury.gov/resource-center/sanctions/Programs/Documents/jcpoa_faqs.pdf).

7 Ladane Nasseri, Samuel Potter, and Golnar Motevalli. “What Investors Need to Know about Entering Iran’s Stock Market,”

According to senior Iranian officials who have recently visited the United States, the government's main targets for foreign investment are mining, energy, the automotive sector, steel, and technology. Iranian officials emphasize to foreigners that investment will not only enable companies to sell to the Iranian population, but also to use Iran as an economic "gateway" to Central Asia.

## Weak Points

Potential investors also will confront a number of troubling and complicated features of the Iranian economy: They will find high inflation and high unemployment/underemployment (roughly 20 percent of the workforce)—although both have been reduced from the years of Mahmoud Ahmadinejad's presidency. A 2015 International Monetary Fund (IMF) mission to Iran reported that early in the current Rouhani administration "prudent policies... allowed the economy to return to positive growth last year (2014) and to reduce inflation to around 15 percent"<sup>8</sup> (At the end of 2011, it was 22 percent.) The Fund mission also indicated that progress was made in stabilizing the currency and reforming government subsidies.

Following these improvements, however, 2015 proved to be a more difficult year due to the global collapse in oil prices, continued sanctions, ongoing mismanagement of many companies, and numerous structural problems. The IMF expected the economy to decline from the 3 percent growth rate it attained in 2014 to between 0.5 and -0.5 percent at the beginning of 2016.

But the Fund also predicted that after the lifting of sanctions, the economy would pick up considerably. A separate report issued by the IMF's Executive Board in

December 2015 stated, "Higher oil production, lower costs for trade and financial transactions and restored access to foreign assets are expected to lift real GDP to about 4-5.5 percent next year [2016]." However, the IMF was not complacent about this being sustainable without major reforms. The same report "stressed the need to advance comprehensive reforms to the policy framework and the economy to sustain progress on macroeconomic stability and to improve growth prospects."<sup>9</sup>

Iran's underlying economic system is badly in need of major improvement in key areas. Transparency is poor in almost all parts of the economy. Financial and business regulations are in great need of modernization, as is corporate governance. The Rouhani administration has taken steps to strengthen the Central Bank in order to improve monetary policy and financial regulation, but the banking system is still weighed down by cumbersome levels of non-performing assets and has been weakened further by a period of detachment from the international financial system. Government subsidies continue to burden the budget and sub-optimally allocate resources.

The December Fund report also underscored that major additional changes are needed to achieve lower inflation, strengthen the Central Bank, enhance the quality of the business environment, and restructure the corporate and financial sectors in order to enhance productivity, growth, and stability.

The World Bank ranks Iran a low 130 out of 189 countries evaluated on its "Ease of Doing Business" Index. Particular problems include difficulty in registering property, obstacles to obtaining construction permits, and inadequate protection of minority investor interests—although in categories such as ease of

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*Bloomberg Business*, January 17, 2016, <http://www.bloomberg.com/news/articles/2016-01-17/what-investors-need-to-know-about-entering-iran-s-stock-market>.

8 "IMF Staff Completes 2015 Article IV Mission to Islamic Republic of Iran," International Monetary Fund, Press Release No. 15/458, October, 5, 2015, <https://www.imf.org/external/np/sec/pr/2015/pr15458.htm>

9 "IMF Executive Board Concludes 2015 Article IV Consultation with Iran, International Monetary Fund," IMF Country Report No. 15/349, December 2015, <https://www.imf.org/external/pubs/ft/scr/2015/cr15349.pdf>.



Central Bank of Iran in Tehran. *Photo credit: Ensie & Matthias/Flickr.*

starting a business and enforcement of contracts, the World Bank rankings indicate that Iran does quite well.

Other international bodies also point to areas where the economy does not stack up favorably, such as inadequate protection of intellectual property rights and a high level of corruption. (Transparency International rates Iran 136 out of 174 countries in its latest survey on corruption.) In June 2015, the intergovernmental Financial Action Task Force (FATF), which sets standards to protect the international financial system from money laundering and the financing of terrorism, pointed to “exceptional concerns” about Iran’s failure to address risks of the latter. Iran will need to focus considerable attention on improvements in these areas in order to attract high quality and sustained investment.

### Bonyads and the Revolutionary Guard

There are certain unique characteristics of the Iranian economy that potential investors need to

recognize in order to make informed decisions. Key to understanding Iran’s economy, and indeed Iran itself, is recognition that the country has two different, and often competing, political structures that play two very different roles. One is the basic governance structure of the Iranian state, the institutions of which are similar to those of many Western countries, with a President, a cabinet, and a parliament. The other is a power structure that sits above this, headed by the Supreme Leader and composed of institutions based on Islamic principles and revolutionary tenets that emerged from the Islamic Revolution. Potential investors will find numerous dynamic private sector companies, but also many businesses that are owned or controlled by entities tied to, or significantly influenced by, this second, religiously and revolutionary driven, power structure.

The two most powerful of these entities are foundations known as *bonyads* and the Islamic Revolutionary Guard Corps (IRGC). *Bonyads* are tax-exempt charitable institutions established after the 1979 revolution and



put under the control of clerics. Their assets include property nationalized at the time by Iran's revolutionary leaders; a great deal of this property was confiscated from the royal family, but property was taken from others as well. The *bonyads* originally were created to fund social work and assist low-income families, former prisoners of war, the families of those killed in war, the disabled, and the handicapped.

In addition to their charitable roles, the *bonyads* now are major factors in Iran's economy. The most powerful are the Bonyad-e-Shahid (The Martyrs Foundation) and the Mostazafin Foundation, also known as the Foundation for the Oppressed and the Disabled. The latter is reputed to be the second largest commercial entity in the country (after the Iranian National Oil Company) with a payroll estimated at over 200,000 and ownership of several hundred companies. A large portion of the *bonyads'* funds not paid out for charitable purposes is reinvested in their businesses. There is controversy in Iran about whether *bonyad* funds have been used for political or military purposes, as these foundations are neither transparent nor accountable to the Iranian Government, reporting only to the office of the Supreme Leader. Their liquid and fixed assets are reported by some observers to amount to as much as 40 percent of the country's overall wealth.<sup>10</sup> Others put the figure in the 20-30 percent range. Due to a lack of transparency, precise estimates are impossible.

Investors in the many Iranian companies that require substantial reform and restructuring could well find the way blocked if *bonyad* partners resist. Many *bonyads* may be reluctant to shed redundant workers in order to boost profits, to disclose their relationships with the top levels of the Iranian power structure, to make their books more transparent, or to provide foreign firms with influence over decision-making. It is also possible, of course, that some *bonyads* that aim for greater profits may be eager to team up with foreign partners who can help them to achieve that goal.

An even larger portion of the economy is probably (although again precise figures are unobtainable) owned by individual members of the IRGC or by the Guard itself. Established to safeguard the Islamic revolution and system, the IRGC has an estimated 125,000 personnel, including ground, air, and naval

forces. It also controls the Basij paramilitary volunteer militia, which is responsible, among other things, for certain facets of domestic security enforcement; it has, according to some estimates, several million members. The IRGC notably includes the powerful Quds Force, which is engaged in military and intelligence activities outside Iran.

Since its origin as an ideologically driven militia, the Guard has assumed great power in virtually all facets of Iranian society. Its enormous involvement in the economy began during the presidency of Ali Akbar Hashemi Rafsanjani and increased substantially under Ahmadinejad, himself a veteran of the Guard.

Rafsanjani saw the Guard—given its tight organizational structure and highly motivated personnel—as the institution most capable of consolidating and implementing the reconstruction of the economy after the 1980-88 Iran-Iraq War. In addition, this role allowed the Guard to reabsorb large pools of war veterans into the economy.

Under reforms initiated by the administration of President Mohammed Khatami in the 1990s, the larger *bonyads* and the Guard were told to divest a portion of their holdings. Many of these, however, were purchased by smaller and even less transparent entities with similar ties to the top echelons of the leadership. Still, the Guard and *bonyads* retain a significant number of important companies.

Ahmadinejad, whose administration stretched from August 2005 to August 2013, launched a major new privatization effort. However, international sanctions prohibited a substantial number of foreign companies from participating in these auctions, and as a result, many companies were purchased by the IRGC, various *bonyads*, and individual or former members of these organizations.

Today the IRGC's reach extends into virtually all major sectors. These include a continuing key role in the construction industry. The IRGC maintains an impressive conglomerate for carrying out construction projects called the *Khatam al Anbiya* (the Seal of the Prophets). The Guard also is actively engaged in both the banking and energy sectors.

### Dilemmas for Potential Investors

Sorting out ownership and control is extremely difficult in Iran. Management responsibility often is unclear,

<sup>10</sup> Steven O'Hern, *Iran's Revolutionary Guard: The Threat That Grows While America Sleeps*, (Washington, D.C.: Potomac Books), 2012, p. 191, <https://books.google.com/books?isbn=1597977012>.

and auditing does not come close to the standards adhered to in the West (or indeed in other parts of the region). The problem represents more than just a management challenge, because under US sanctions that will continue after Implementation Day, individuals and entities that remain on the SDN List will still be “off limits” to American companies and their foreign subsidiaries. Foreign companies or banks dealing with these “off limits” entities will continue to incur risks of secondary US sanctions.

Apart from sanctions-related issues, the power of the IRGC and *bonyad*-associated entities also creates a tilted playing field. Private sector Iranian companies themselves complain that shareholding by IRGC or *bonyad* affiliates confers undue advantage on many Iranian companies, enabling them to win large government contracts and to more easily obtain bank loans.

Foreign investors will have to consider whether investing in such companies would be an advantage or a disadvantage. Partnering with them would give a foreign company a lot of influence in obtaining contracts and regulatory approvals. However, this same relationship could undercut foreign partners if an internal dispute were to lead to judicial action. Regardless of whether the matter actually went to court, intense political pressure could be brought to bear on foreign investors to comply with the wishes of their powerful Iranian partner. There is an additional potential risk to a company’s reputation in associating with an IRGC or certain *bonyad* affiliates.

Investors also must take into account that Iran’s actions outside the parameters of the nuclear deal could subject it to additional sanctions. Recent ballistic missile tests demonstrate this risk; they were not a violation of the JCPOA but did violate UN Security Council resolutions. President Barack Obama announced new sanctions on Iranian individuals and foreign entities for missile-related activities on January 17, just as JCPOA-related sanctions relief went into effect.<sup>11</sup>

Potential investors also will have to weigh the prospects and ramifications of a “snapback” in sanctions should Iran violate key parts of the nuclear deal. American negotiators have made clear, especially to the Congress as part of the approval process, that the United States has the ability to engineer just such a snapback in the event of serious non-compliance. It is not certain what sorts of actions would trigger this mechanism or exactly how many other countries would go along with a full return to pre-JCPOA sanctions, but it remains a factor for consideration nonetheless.

There is also the question of the sustainability of Iran’s investment laws. The Foreign Investment and Promotion Act, passed over a decade ago, provides opportunities for foreigners to own up to 100 percent of an Iranian company, obtain three-year residence visas, benefit from generous government investment incentives, and repatriate profits in foreign currencies. It also offers assurances regarding compensation in the event of expropriation. However, there remains the danger that still strong nationalist forces in Iran could press for restrictions if foreign interests appear to be playing too great a role in Iran’s economy.

By engaging with private sector companies and younger Iranians—including women entrepreneurs—Western investors would likely strengthen the role of these groups in the nation’s economy and, over time, in its political life.

### Benefits of Foreign Investment for Iran

Foreign investment under the right conditions can support both Iran’s political and economic evolution. By engaging with private sector companies and younger Iranians—including women entrepreneurs—Western investors would likely strengthen the role of these groups in the nation’s economy and, over time, in its political life. It would be naive to think that major changes will occur soon, but also unduly pessimistic to believe that they will never happen, especially as foreign contacts increase and new generations of Iranians grow in influence. Such openness has resulted in major changes in far larger countries, such as China. Even

Americans Leave Iran; U.S. Places New Sanctions,” *New York Times*, January 17, 2016, [http://www.nytimes.com/2016/01/18/world/middleeast/three-freed-americans-depart-iran-one-remains-us-officials-say.html?ref=world&\\_r=0](http://www.nytimes.com/2016/01/18/world/middleeast/three-freed-americans-depart-iran-one-remains-us-officials-say.html?ref=world&_r=0).

11 David E. Sanger, Rick Gladstone, and Thomas Erdbrink, “3 Freed



the prospect of more job-creating investment could produce additional popular support for reformists.

### Difficult Decisions in Iran

To achieve significant and sustained economic progress, Iran's leadership will have to make tough decisions. In numerous pronouncements, Rouhani has indicated his recognition of the need for substantial reform, focusing on increased tax compliance, cutting subsidies, and an improved banking system. But implementation of these measures has proven to be complicated.

Several new economic challenges face Iran as a result of the nuclear deal. First, how will the government use newly unfrozen funds repatriated from blocked accounts abroad? With considerable sums already obligated to creditors, the amount actually available for use at the discretion of the government is likely to be in the range of \$30-\$50 billion. Substantial additional oil revenue is anticipated, but the exact figures are uncertain.

In the past, large inflows of money have proven destabilizing, widening the wealth gap. During the 1970s, I witnessed first-hand the disruption produced by higher oil prices. At first, they appeared to provide a major benefit and to give a boost to the popularity of the Shah. In time, however, they proved to be a significant factor in ending his regime. They produced high inflation, exacerbated already substantial infrastructure bottlenecks, and pushed up the foreign exchange value of the rial, making Iranian exports less competitive. Perhaps most importantly, they widened income disparities and focused popular attention on corruption in the distribution of the nation's oil wealth. Iranians have seen similar scenarios play out since the Revolution.

Likewise, many Iranians would be concerned if it became known that large additional sums were to be spent in support of allies and surrogates in Syria, Yemen, Iraq, Gaza, and Lebanon rather than being used at home. Iranians would want to see the money go to them directly in the form of higher wages and social benefits, as well as construction projects that create new jobs.

Precisely how rapidly public monies are spent also represents a complicated issue: Permitting a sharp increase in wages or abruptly launching a large public works program could quickly push up inflation and

interest rates, which would harm low and middle-income Iranians. Likewise, this approach could damage the climate for domestic and foreign investment.

### Rebuilding Energy Infrastructure and Diversifying the Economy

A key way of boosting the economy would be a multi-year program to rebuild and revitalize the country's oil production, refining, and transportation capacity. Development of the energy sector has been hindered by sanctions that restricted investment in oil and gas fields, constrained the import of parts and equipment, and cut sharply into oil exports. Building a significant refining capacity, which the country currently lacks, will likely be a high priority for the future.

Nonetheless, new energy investment alone is not an adequate strategy for achieving stable, long-term, inclusive growth. That depends on major investment in other sectors as well, especially in small- and medium-sized private enterprises. To improve prospects for such investment, key gaps highlighted in the World Bank's Ease of Doing Business Report need to be remedied. The World Bank report underscored, for example, Iran's inadequate protection of minority investor interests.<sup>12</sup> Substantially improving that protection would give greater assurance to investors.

Modernization and improvement in small- and medium-sized enterprises does not necessarily mean emulating American or European models. There are good examples in Iran's own neighborhood. Turkey, for example, a country roughly the same size as Iran, substantially improved its investment climate over the last decade and has a thriving small- and medium-sized industry sector; it ranks number fifty-five on the World Bank Ease of Doing Business Index. Just across the Persian Gulf, the United Arab Emirates has excelled at attracting investment and supporting new companies; it ranks number twenty-two on the index.

### The Ownership Issue and Iran's Power Structure

Iran's leaders will have to determine whether or not they are prepared to undertake serious reform of company ownership and control—e.g., requiring IRGC or *bonyad* divestment in major companies or calling for their roles to be limited. The latter could be achieved

12 "Economy Rankings," World Bank Group, June 2015, [www.doing-business.org/rankings](http://www.doing-business.org/rankings).

by ensuring that companies are permitted to operate on the basis of market-oriented rather than politically directed decisions, and requiring transparency rather than allowing current highly opaque reporting and bookkeeping practices to continue.

A debate has been underway for several years on the proper economic role of the IRGC. In September, 2013, President Rouhani said that “the IRGC must . . . take on three or four large projects. . . . It is not a rival to the people or the private sector. . . [it] must take on important projects that the private sector is *unable* to do.”<sup>13</sup> (Emphasis added.) The thinly veiled message was that the Guard should cut back its activities in various parts of the economy to allow more scope for private sector activities. What specific roles, or companies, he had in mind for the Guard to give up was unspoken.

A few days later, the Supreme Leader weighed in on the matter. Paying deference to the IRGC’s role “to guard the revolution,” he added, “I don’t want to say that this guardianship has to stretch to all spheres—scientific, intellectual cultural and *economic*.” (Emphasis added.) “I don’t mean this,” he explained. “I mean that the IRGC has to know what it is guarding.”<sup>14</sup>

While his language was somewhat opaque, the direction of his thinking and his intent that the IRGC perhaps should curtail the extent of its purview was promising. Nonetheless, little change has occurred in the economic role of the IRGC since these statements were made.

Experts who have followed this debate appear to see calls for a reduction of the IRGC’s role in the economy as a practical move to improve the country’s economic performance, in part because observers often charge that a number of businesses it runs are badly managed. Moreover, its role in numerous companies (as noted

above) makes them vulnerable to Western sanctions or subject to potential investor concerns about partnerships. According to Mehdi Khalaji, a senior fellow at the Washington Institute, Rouhani “. . . may have convinced the Supreme Leader that . . . attracting foreign investors and improving management would be much easier if the IRGC agreed to curb its economic appetite.”<sup>15</sup> It remains to be seen if the Supreme leader is fully persuaded of the desirability of achieving these goals and curbing the Guard, and will act to do so.

### Managing the Rial

Another challenge will be preventing sharp appreciation of the rial and macro-economic distortions from large inflows of money that are expected from additional oil revenues and the reflow of blocked funds. History suggests that the immediate challenge the Rouhani government will face will be avoiding a sharp appreciation of the rial that would reduce the competitiveness of non-energy Iranian exports, particularly in the manufacturing sector. The government would also need to resist pressures, as noted above, for sudden large-scale spending that would increase inflation and for the misallocation of resources in wasteful projects, including by providing large and unproductive subsidies or loans to privileged elites.

There are tools that could help in managing the process. The authors of the IMF Report “. . . urged the authorities to implement the recent stimulus package cautiously and to support it by announcing broad monetary and inflation objectives for 2017/18 to better anchor inflation expectations and the exchange rate.”<sup>16</sup> Another policy measure would be to channel a substantial portion of the funds Iran receives into the National Development Fund of Iran (NDFI). This was founded in 2011 as a sovereign wealth fund to succeed the previous Oil Stabilization Fund,

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<sup>13</sup> Mehdi Khalaji, “President Rouhani and the IRGC,” *Washington Institute*, January 8, 2014, <http://www.washingtoninstitute.org/policy-analysis/view/president-rouhani-and-the-irgc>.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> “IMF Staff Completes 2015 Article IV Mission to Islamic Republic of Iran,” International Monetary Fund, December 2015, p. 8, op.cit.

which was designed to reduce volatility from oil price gyrations.

The Fund originally received 20 percent of the country's oil and gas revenues, a figure that was scheduled to rise by 3 percent annually for five years. It invests these revenues in Iranian private sector companies and other companies partially owned by the government, as well as in foreign investment projects abroad and ventures undertaken by foreign investors in Iran. The Fund is not included in the government's budget. It is headed by a Board of Trustees of eleven government officials and chaired by the president.

The NDFI, however, is another of Iran's opaque financial institutions. To ensure that the money is suitably allocated, it needs a clear mandate to decide on investments *independent* of the influence of clerics, the IRGC or the government—and *full transparency*—a stretch given the way resources are allocated in Iran today.

If Rouhani wants to ensure the efficiency and credibility of the decisions of the NDFI and can obtain the needed political support, there are excellent models of well-managed sovereign wealth funds, such as those of Singapore and Norway—where decisions are fully shielded from domestic politics, highly transparent, and based on sound market principles. There are internationally agreed guidelines for effective sovereign wealth funds known as the Santiago Principles available, as well.

## Conclusion

It is, of course, impossible to know with any degree of certainty how Iran's economic policies or political structure will develop in the years ahead. However, Iran should not be seen as a monolithic nation. Reforms that enhance transparency and broaden private ownership at least have a chance of facilitating economic progress and greater openness. There are precedents: Once thought by most observers also to be monolithic and wedded to a single economic model, China has implemented a wide range of economic reforms scarcely envisaged several decades ago; and formerly insular and isolated Myanmar has chosen to pursue a reformist course, as well.

There are great uncertainties for Iran in the period ahead—with sizable opportunities, as well as sizable risks—for Iranians and for foreign investors. While harboring no illusions about the current hard line

among many of Iran's top leaders toward the United States and the West, or about their ongoing disruptive political/military activities in the region, their troubling human rights policies, and their continuing support for Hezbollah, observers also need to take into account the importance of political and social pressures, especially from young Iranians, for improved living standards, increased job creation, expanded contact with the outside world, and greater responsiveness of the government to their views. These already have produced shifts in thinking within some segments of the country's leadership. But strong resistance remains, as evidenced by the recent decision of the Guardian Council (consisting of six legal experts and six Islamic scholars) to ban large numbers of reformers from running in the February 26 elections for the Majlis (parliament) and the Assembly of Experts (the body that will select the next Supreme Leader).

While Americans will not play a major role in the Iranian economy for some time, the United States can at least take another step forward toward normalization by utilizing those limited business contacts that do exist, and will grow modestly in the period ahead, to enhance the economic reform process. And Iran's ability to advance the course of economic and political normalization with the West, even incrementally, will depend, at least in part, on Washington implementing the US side of the JCPOA, which in turn is based on Iran continuing to uphold its commitments as well.

We cannot, of course, be naive about Iran; clearly, the removal of sanctions is no panacea. However, this agreement creates potential opportunities for a more open and constructive set of economic relations between Western nations and Iran on which to build, over time, greater cooperation in other areas. Nothing is guaranteed, of course, and things might not work out this way. Yet failing to take advantage of these opportunities would be to miss a chance, however small some may see it, for progress at this historic moment.

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