

## Iran & Iraq: A deadly new crisis with the US

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- We believe that de-escalation will continue following statements from both the Iranian and US leadership. Although both parties tentatively appear to be standing down, this could break down easily and retaliatory acts could resume.
- The crisis will shelve (but not necessarily kill off) the JCPOA nuclear deal. It will also bolster the hardliners in Iran ahead of elections in February, making the dire state of the economy a secondary issue.
- Iraq, where both attacks took place, will bear much of the initial brunt. The presence of US troops is already an open wound, complicating any moves towards a stable government.

### Why a direct US-Iran war won't happen

Official statements from both US President Donald Trump and the Iranian leadership indicate that both parties appear to be standing down in the wake of an Iranian missile launch on an Iraqi base housing US troops that was in response to the US assassination of Iranian Quds Forces General Qasim Soleimani.

- A best-case scenario sees both sides getting back to the negotiating table in the short- to medium-term, with commodity markets reflecting their initial hunch that this crisis shall pass, as did the one after the Aramco attack last September.
- The worst-case scenario would be further direct tit-for-tat, probably in Iraq and a few other regional countries. This would cause havoc in international politics, security and commodity markets.
  - It is not clear how this would play in US politics -- where there is little appetite for foreign adventures -- but the crisis is already a boost for conservatives in Iran, where a parliamentary election will take place on 21 February.
  - If the crisis escalates into significant further direct or indirect confrontation, we judge that oil could reach USD 90 pb in very little time.
- Our baseline scenario, however, is continuation of the de-escalation that has already begun to unfold, allowing commodity markets to resume balance. The Iranians, who also cannot afford war, could decide to not take any further action.
  - We do not, however, rule out the potential for the rapid resumption, from both sides, of low-level attacks in neighbouring countries, through acolytes such as Hezbollah, Hamas, the Houthis, etc. This would mean a resumption in the upward pressure on the price of oil.
  - However, we do not see disruption possible in the Strait of Hormuz, as Iran would chop off its own nose, as of its allies and friends such as Qatar and China.

Table 1 - Iran Macroeconomic Indicators<sup>1</sup>

	2015/16	2016/17	2017/18	2018/19	2019/20f
Real GDP Growth (%)	-1.6	12.5	3.7	-3.9	-9.5
Crude Oil Production (M Bpd)	2.9	3.6	3.8	3.4	2.5
CPI Inflation (%)	11.9	9.1	9.6	28.1	34.1
Fiscal Balance (% of GDP)	-1.8	-2.3	-1.4	-3.2	-4.2
C/A Balance (% of GDP)	0.3	4.0	3.8	4.3	-0.4
Total Gov't. Gross Debt (% of GDP)	38.4	47.5	39.5	33.2	30.0
Total Gross Extn'l Debt (% of GDP)	5.6	2.1	2.0	2.0	2.0
Gross Official Reserves (Mos. of Imports)	19.4	15.5	15.2	16.8	16.2
Nominal GDP (USD B)	375.4	404.4	430.7	452.3	484.7
Population (Millions)	79.3	80.2	81.1	82.0	83.2

- Saudi Arabia's state-owned shipper, Bahri, suspended its routes through Hormuz and Aramco is now using the 750km East-West pipeline for export, but it only has a 5 Mb/d capacity instead of 7.5 Mb/d, thus putting upward pressure on oil price
- Meanwhile, developments over the past two weeks have quashed any potential conciliatory talks between the US and Iran, and have effectively shelved progress on the JCPOA for the foreseeable future.
  - This is not the same, however, as saying the nuclear deal is completely dead.
    - Although Iran decided to remove the cap on the number of centrifuges it can have, it says it will continue to cooperate with the International Atomic Energy Agency in monitoring its sites.
    - It has also stopped short of announcing an increase in uranium enrichment by 20%, which would have reduced the time to obtain material for a bomb.
  - The JCPOA has anyway been under severe stress since the US withdrew from it in 2018.
- Reaction to the Iran-US developments has generally been negative, both in the US and internationally.
  - US President Donald Trump authorised the attack without congressional approval, triggering sharp political divisions in the US, even among some Republican lawmakers.
    - In an attempt to prevent further action against Iran, US Speaker of the House Nancy Pelosi announced that her chamber, controlled by the Democrats, will vote on a war powers resolution -- a federal law intended to check the US president's power to go to war without congressional consent.
    - While the resolution will pass in the House, it is unlikely to pass in the Senate because of the Republican majority who have largely supported Trump's policy towards Iran.
  - The US appears to have acted without consulting its allies, driving another wedge between them and the current US administration.
  - Both French European Affairs Minister Amelie De Montchalin and UK Foreign Secretary Dominic Raab called for de-escalation from all parties.

<sup>1</sup> Arabia Monitor; IMF.

- US Secretary of State Mike Pompeo said the Europeans had not been as helpful as Washington would have liked.
- Trump has called for more support from NATO and for other countries to ditch the JCPOA.
- Russia and China condemned both attacks, while Israel gave its cautious support to the US.
- Regionally, Iran's rivals Saudi Arabia and the UAE have called for calm and a de-escalation of tensions.
  - Saudi Arabia's position in the coming months will be of note given the attack on its oil facilities in Abqaiq and Khurais fields in September 2019, believed to have been conducted by Iranian-backed forces.
  - Another actor to watch is Qatar, which has tried to position itself as a mediator in the current conflict. Given Qatar's history of hosting and mediating talks between hostile factions, including between the US and the Afghan Taliban, the country may try to play a role in any future negotiations. It is not clear to us that there will be much regional appetite for such a role at this delicate time. It is also arguably the case that the matter is much above Qatar's weight.

We see US action rebounding on moderates in Iran who had been seeking more conciliatory relations with the West. While the attack removed the Quds leader, it will not deter the force's power and influence, and coming a month before Iranian parliamentary elections, the killing will also play into the hands of hardliners in Tehran.

- Following the killing, Iran was quick to appoint Soleimani's deputy -- Esmail Ghanni -- to replace him.
  - Ayatollah Khamenei called for three days of mourning following the attack, which have been marked by large "Death to America" protests.
  - The event has united Iranians as well as political factions in the country as millions of Iranians have poured into the streets for the general's funeral.
  - Supporters of Trump's action have suggested that Iranians have been coerced into demonstrating, but journalists in the country who have previously covered state-sponsored rallies, where crowds get bused in, have suggested the outpouring of people has been far greater than on such occasions.
- We now expect to see hardliners capitalise on the event by gaining parliamentary seats in the elections.
  - The reformist coalition, "List of Hope", which had a sweeping victory in the 2016 parliamentary election is expected to maintain its support in urban areas, but it will not achieve the outright majority it almost won in the last election cycle.
  - Members of the 290-seat parliament are elected every four years, with 146 seats needed for a majority. Almost 16,000 people have registered to compete.
  - Some prominent candidates running include hardliners such as former Tehran mayor and Revolutionary Guard commander Mohammad Qalibaf as well as Mohammad Hosseini and Ali Nikzad, who were ministers under former hardline President Mahmoud Ahmadinejad.

Hardliners	Against all interaction with the West
	Maintain that other factions are anti-revolutionary
	Against the nuclear deal & the actions of the current government
Moderates	Seek cordial relations and further outreach with the West
	Hold a softer approach on social issues
	Maintain loyalty to the revolution
Reformists	Supported normalised relations with the West
	Loyal to the revolution, but critical of current political landscape
	Worked to preserve the nuclear deal

- Soleimani's death will add ammunition to opponents of the (relatively) moderate government of President Hassan Rouhani, which is already struggling to overcome an economy battered by US sanctions.

### Iraq caught in the crossfire

The attack on Soleimani has already dragged Iraq (where he was killed) into the crisis. It will further delay the creation of a stable Iraqi government, which was already being held back by protests by young Iraqis seeking a new political order.

- The political gridlock is expected to continue for the foreseeable future as Iran-backed political factions work to consolidate power and protesters continue to push back against foreign intervention in the country.
  - Prime Minister Adil Abdul-Mahdi resigned in December 2019 but has remained as a caretaker until parliament approves a replacement.
- The presence of US troops in Iraq has leapt to centre-stage, threatening to destroy already fragile US-Iraqi relations.
  - As we had anticipated, the Iraqi Parliament responded to the killing by calling for the expulsion of US troops from the country and Abdul-Mahdi called the assassination a violation of the conditions for the US troop presence. This is arguably a more important (political) win for Iran than the retaliation on Wednesday the 8<sup>th</sup> against the two US military installations -- Al Asad Air Base, along with an air base near Erbil in northern Iraq.<sup>3</sup>
  - We note that most Sunni and no Kurdish parliamentarians were present at the vote, highlighting the sectarian split over the US presence in Iraq.
  - Trump has responded to the (non-binding) parliamentary vote by insisting that the US will not leave the country until Iraq pays back the money it spent on building an air base. He has also threatened to impose sanctions as a retaliatory measure against any anti-US moves by Iraq.
- The international coalition of troops fighting ISIS has been suspended -- leaving an opportunity for the terrorist group to increase activity in the country.

<sup>2</sup> Arabia Monitor.

<sup>3</sup> Chief Economist of Arabia Monitor, Dr. Florence Eid-Oakden's interview with Bloomberg on Iran. <http://bit.ly/35vsm19>.

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