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## **Détente with Iran?**

On September 28<sup>th</sup>, President Obama reportedly called Iranian President Rouhani to confer over American and Iranian relations. In addition, Iran's nuclear program was discussed. This was a historic event—the first documented call between a U.S. president and his counterpart in Iran in 35 years. The last time such a conversation occurred was when the Shah was in power.

Naturally, this gesture is important. Iran and the U.S. have been enemies since the fall of the Shah. The Iranian Revolution removed a strong ally from power and replaced it with a regime opposed to U.S. hegemony in the region. Although the U.S. and Iran have cooperated on occasion (Iran agreed to protect any allied pilots that landed in their territory during the Gulf War, offered similar guarantees during the early days of operations in the Afghan Conflict and participated in the arms-for-hostages deal that became the Iran-Contra Scandal), for the most part, the U.S. has tried to contain Iran and has publicly acknowledged it supports regime change.

Iran's nuclear program has been of greatest concern. Iran has been working on a program of uranium enrichment for years. The nuclear program, which began under the Shah and was suspended by Ayatollah Khomeini only to restart after his death in 1989, has steadily expanded its size and scope. It is estimated that Iran has over

21,000 nuclear centrifuges operating or ready for installation.<sup>1</sup>

The U.S., in particular, and the West, in general, hold the position that an Iranian nuclear weapon would be a major problem for the Middle East. At best, it would trigger a nuclear arms race in the region. At worst, Iran would use its capability to threaten its neighbors and dominate oil flows from the region. Thus, the U.S. and other Western nations have steadily increased economic sanctions in an attempt to coerce Iran into ending its nuclear program. To date, sanctions have failed to achieve this goal.

However, the unexpected election of Rouhani,<sup>2</sup> a moderate political figure, has raised hopes that a diplomatic deal can be achieved. Rouhani has clearly changed the tone from the previous Iranian president, Ahmadinejad, who was prone to making inflammatory statements that provoked hostility from Israel and the West. However, it is unclear if Rouhani's election is enough to foster a détente with Iran.

In this report, we will discuss the basic goals of the U.S. and Iran, how recent events may be shaping a diplomatic thaw and the obstacles to new relations. As always, we will conclude with market ramifications.

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<sup>1</sup> Iran Watch, Sept 18, 2013.

<sup>2</sup> See WGRs: 6/24/2013, [The Iranian Surprise](#); 5/28/2013, [Elections in Iran](#).

**The Goals of Iran and the U.S.**

America's goal in the Middle East is fairly straight forward. It wants the free flow of oil from this region, which has the largest conventional oil reserves in the world. To ensure that no outside power can dominate the region, the U.S. maintains a significant military presence in the area. At least one, and sometimes two, U.S. carrier groups operate offshore and the U.S. Fifth Fleet bases itself in Bahrain. Stability has been paramount. The U.S. built a coalition to oust Saddam Hussein from Kuwait in 1991 and has supported authoritarian regimes to quell communist and jihadist insurgencies. If the region's oil reserves were to fall into the powers of an enemy (a key worry during the Cold War) or if access were denied by a regional power, the global economy would be in great peril. Thus, the U.S. wants to ensure the security of oil supplies from the region. Of course, the U.S. wants to achieve this goal as economically as possible; after all, the security of oil supply is a global public good, provided by the American superpower, mostly funded by U.S. taxpayers.

Iran's goals are somewhat more complicated. Iran ultimately wants to be the regional hegemon. It believes that it is the strongest power in the area and wants to dominate it. Given that this is impossible as long as the U.S. is operating in the Middle East, its secondary goal is to ensure its government remains in place (thus, no regime change). In addition, it wants to spread its form of revolutionary Shiite Islam across the Muslim world.

**Recent History**

Since the Iranian Revolution, the U.S. and Iran have been trying to meet these aims. Initially, to contain Iran, the U.S. supported the Sunni powers in the Middle East, especially Iraq. During the Iran-Iraq War,

the U.S. offered logistical support to the Iraqi government. Although U.S. behavior could be described as Machiavellian, the U.S. was able to use the balance of power between Iran and Iraq to maintain the status quo in the region.

This balance began to unravel after the Gulf War. The U.S. wanted Saddam Hussein out of power but did not want to execute the ouster militarily. Thus, sanctions, intrusive weapons inspections and no-fly zones were deployed to prevent Iraq from projecting power. The problem with this program was that Iraq became progressively weaker but Saddam Hussein remained in power. At some point, Iraq would have weakened to the point where Iran would have been tempted to finish the Iran-Iraq War by ousting Hussein themselves.

Of course, history didn't work out that way. Hussein was apparently engaged in a massive ruse to convince Iran that it had a nuclear weapons program to discourage an Iranian invasion. Unfortunately, the ruse was good enough to bring a U.S. military response and the ouster of Hussein from power.

For Iran, the American invasion of Iraq was a godsend. It eliminated its most proximate enemy without firing a shot. The U.S. and its allies became bogged down in a civil war between Sunni and Shiite militias. Iran aided and abetted the conflict, sometimes delivering weapons and improvised explosive devices to both sides. The conflict essentially came under control only after the 2007 "Surge" which pulled elements of al Qaeda away from the Sunni tribes. The Sunnis were a strong enough force to bring a balance of power to Iraq and the ensuing stability allowed the U.S. to withdraw from the conflict.

In 2011, when U.S. troops left Iraq, Iran was in a very strong position. Given its influence in Iraq, its ties to Hezbollah and its ally with the Assad regime in Syria, discussions about a “Shiite arc” became commonplace. Sunni powers in the region became concerned about Iran’s growing influence.

However, just as it appeared that Iran had “fallen into the catbird’s seat” at America’s expense, conditions in Syria began to deteriorate. A series of protests was handled poorly by the Assad regime, which wildly overreacted to the criticism. The situation rapidly escalated into a broad civil conflict, where insurgent groups battled government forces and each other. Iran committed Republican Guard troops to the conflict and deployed Hezbollah as well. Despite this effort, it has become clear that neither side can likely prevail and Syria may be engaged in a civil war for years, much like what was seen in Lebanon during the 1970s.

The Syrian Civil War has become a proxy conflict between Shiite and Sunni powers. The U.S. has offered token support to the rebels but is worried about more potent weapons falling into the hands of jihadist groups that operate in Syria. After the Assad regime used chemical weapons, the U.S. threatened bombing raids, but decided not to move forward on the attacks in lieu of diplomatic efforts, sponsored by Russia.<sup>3</sup>

In addition to finding itself bogged down in Syria, steadily tightening economic sanctions have been hurting Iran’s economy. Inflation is running around 40% and unemployment is over 12% for the entire workforce and estimated to be nearly 25% for 30-year-olds. Iranian oil exports have declined. To a great extent, Rouhani’s

election was due to voters looking for an exit from economic distress.

### **Détente?**

There is a compelling case for Iran and the U.S. to normalize relations. Iran’s economy is coming under tremendous strain from economic sanctions. The U.S. is trying to define what its global role will be, but in any case wants to reduce its involvement in the Middle East. The outlines of a deal are fairly simple. Iran agrees to persistent and deep nuclear inspections. Although the IAEA cannot guarantee Iran won’t decide at some point to “race for a bomb,” the inspections will at least give warning to the world. Although the West is rightfully worried about Iran with a bomb, a quote from Ayatollah Khamenei probably frames the issue most clearly.

*If we wanted to make nuclear weapons, how could you prevent it? If Iran was determined to have nuclear weapons, America could not prevent it in any way. We do not want to make nuclear weapons. Not because America is upset over this but because it’s our belief. We believe that nuclear weapons are a crime against humanity and must not be produced and that those that exist in the world must be eliminated. This is our belief. It has nothing to do with you. If we did not have this belief and decided to make nuclear weapons, no power could prevent us, just as they were not able to prevent it in other places—not India, not in Pakistan, not in North Korea.<sup>4</sup>*

In most major religions, there are “just war” theories and there are usually prohibitions against indiscriminate homicide. Nuclear weapons, by their nature, are not battlefield weapons but are designed for mass

<sup>3</sup> See WGR, 9/30/2013, [Putin’s Gambit](#).

<sup>4</sup> *Foreign Affairs*, Sept/Oct 2013, volume 92, number 5, article “Who is Khamenei,” page 45.

destruction. In their only use in wartime, the goal was to signal to Imperial Japan that the bombs would completely destroy their civilian population. Ayatollah Khamenei has made statements similar to the one above, where he has prohibited the use of nuclear weapons.

So, if the Ayatollah opposes such weapons, why does Iran have a nuclear program? The program seems to go well beyond what would be required for civilian use only (as Iran claims). We believe Iran wants to achieve a level of nuclear proficiency that would allow it to develop a weapon in a short amount of time. On the other hand, there isn't much benefit to actually having a weapon because such development would likely trigger, at best, even harsher sanctions and, at worse, a military response. The aforementioned *Foreign Affairs* article notes that the Ayatollah is aware that former Libyan leader Moammar Gadhafi ended his program and his reward was removal from office by the West. Thus, Iran has little incentive to end its program but a strong desire to have the capacity to build a weapon if for no other reason than to discourage a Western incursion.

In return for an inspections regime, the U.S. would relax sanctions on Iran which would allow (at least in theory) its economy to recover. The biggest benefit would be to increase global oil supplies and reduce prices. In addition, if the U.S. can come to an agreement about Iran's projection of influence in the region, allowing for the corralling of Hezbollah and guarantees on freedom of navigation through the Strait of Hormuz, the U.S. could reduce its military "footprint" in the region. This would allow America to address issues in Asia and Europe.

There is both domestic and international opposition to a deal. Congressional opposition will be high. For Jacksonians,<sup>5</sup> normalizing relations with a nation that held our citizens captive is a non-starter. For evangelicals, the potential danger to Israel of leaving the Mullahs in control of Iran is simply unthinkable.<sup>6</sup> And the traditional Israel lobby will oppose a deal.

Similar domestic opposition will be strong in Iran as well. From the 1953 coup against the government of Mohammad Mosaddegh (which was co-executed by the CIA) to the long-time support of the Shah, Iranians within the ruling class view the U.S. as the "great Satan." In addition, the Republican Guard and most of the clerical elite have been spared from the economic sanctions that have crippled the broader economy. And so, Rouhani's overtures to the U.S. are not being taken well within much of Iran's ruling elite. So far, Ayatollah Khamenei appears to be supporting efforts to engineer a thaw. However, it isn't clear how much room Rouhani has to negotiate; if progress doesn't occur quickly, the opportunity to forge a deal may pass.

International opposition will be broad as well. The Sunni powers in the Middle East are very worried that a deal will be struck which would leave them isolated against Iran. The Gulf kingdoms are no match for Iran and thus would be forced to make accommodations with the clerical regime. Israel is terrified of an American downgrade of interest in the region. Israeli PM Netanyahu has been very vocal about the dangers that Iran poses to the region. Interestingly enough, both China and Russia would prefer the U.S. to stay heavily involved in the region. For the latter, it

<sup>5</sup> See WGR, 1/9/2012, [The Archetypes of American Foreign Policy](#).

<sup>6</sup> See WGR, 8/27/2012, [Israel and the Evangelicals](#).

keeps the U.S. from interfering in its retaking of the “near abroad.” For China, having the U.S. police the Middle East means that China can gain access to the region’s oil without the cost of overseas military commitments.

If the U.S. and Iran strike an agreement, the rest of the world will need to adjust. Iran’s influence in the region will grow. However, it isn’t obvious that Iran is powerful enough to keep the peace. Sunni jihadist groups are becoming increasingly powerful; in Iraq, for example, violence is reaching levels last seen in 2008, shortly after the Surge began. Most of this violence is Sunni versus Shiite. The feared “Shiite arc” is starting to appear quite frayed. Syria is now a nation in name only. It is rapidly devolving into fiefdoms managed by Kurds and various Sunni groups. In addition, Turkey is a rising power in the region and could eclipse Iran in the future.

There will be great internal and external opposition to a normalization of relations with Iran. These actors may be able to scuttle a deal. At the same time, the U.S. and Iran would both benefit from normalization if it allowed the Iranian economy to recover and allowed the U.S. to reduce its military commitment to a dangerous region of the world.

U.S. presidents have made arrangements in the past with sworn enemies when conditions warrant. The two most famous,

Franklin Roosevelt’s deal with the Soviets during WWII and Nixon’s normalization with China, occurred when the U.S. was vulnerable, had a practical reason for doing so and found their erstwhile enemy with unmet needs as well. Such moves require great political skill and it isn’t evident that the White House possesses such dexterity at the moment. However, if the opportunity is great enough, sometimes what appears to be impossible does occur.

### **Ramifications**

The most obvious outcome from a normalization of relations between Iran and the U.S. would be a drop in oil prices. Such an arrangement would reduce the risk premium in oil as one of the primary geopolitical threats would be reduced if not eliminated. However, this calm may not last. There will likely be a reaction from Israel and the Gulf kingdoms that may trigger a conflict. The odds of such a reaction are low but not zero. In fact, if Israel really does view Iran as an existential threat, a military strike may be the only way Israel can pull the U.S. back into the region.

Overall, an agreement will probably be bullish for risk assets. Equities would likely rally and Treasuries would probably weaken. The dollar would likely rally as well.

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