The recent implementation of the Iran nuclear deal (Joint Comprehensive Plan of Action, or JCPOA) will have a profound impact on the Middle East. From heightened tensions between Iran and Saudi Arabia to Iran's ability to finance terrorist proxies with sanctions relief, there are many reasons for Iran's neighbors to worry. But not every country is fraught with concern. Turkey has hailed the deal as a diplomatic success. More to the point, Ankara sees the potential for real economic opportunity with its long-sanctioned neighbor. As this report from Roubini Global Economics explains, a more prosperous Iran with access to foreign currency affords Turkey a new market to sell industrial and commercial goods, and to offer tourism services, as well. Energy, not surprisingly, will dominate Iran's exports to Turkey.

But Ankara, much like the rest of the world, will need to be careful how much it relies on Tehran. The fear of Iran violating the JCPOA, and thereby inviting renewed international sanctions, is a constant factor among all of the many countries and companies looking to cash in on the economic opportunities. Of course, Turkey has already taken great liberties by exploiting a loophole in those sanctions by executing an elaborate “gas-for-gold” sanctions-busting scheme that yielded Iran some $13 billion in Turkish gold from 2012 to 2013. This “golden” loophole was closed by the U.S. Congress in 2013.

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1. This analysis is coauthored by FDD’s Center on Sanctions and Illicit Finance and Roubini Global Economics. As an independent economics research firm, Roubini Global Economics does not take a view on which policies the U.S. should adopt with respect to Turkey or Iran. FDD is a non-profit, non-partisan, policy institute whose experts have written extensively on U.S. policy toward the two countries. Both organizations believe that a better understanding of economic factors and trends can help inform policy choices.


The JCPOA has now lifted substantial sanctions against Iran, and Turkey is looking to profit in more traditional ways through legal trade and investment. But as the Roubini team acknowledges below, the relative advantages that Turkey will have in the early going may wane over time as Iran becomes more competitive, and the two may compete over investment from third countries. And over the long term, Ankara’s ability to cash in hinges on Iran’s ability to implement economic and financial reforms. And that is certainly not guaranteed. The political pragmatists generally associated with such reforms may be increasingly sidelined in this month’s elections.

In the meantime, it is not entirely clear if the current political climate is supportive of an uptick in Turkey-Iran economic ties. While Ankara had nothing to do with Saudi Arabia’s controversial execution of Shiite cleric Nimr al-Nimr in early January, the Iranian press linked it to a visit to Riyadh by Turkish President Tayyip Erdogan. In response, Turkey summoned Iran’s ambassador and harshly condemned the media reports.

Turkey’s December deployment of troops near Mosul to train and aid local Sunni and Kurdish forces to fight against the Islamic State also elicited some harsh Iranian reactions. Turkey is, of course, a Sunni country aligned with NATO whose vision for Syria and Iraq is antithetical to that of Tehran. Iran therefore responded that the troops would create chaos and risk regional security, while calling on Ankara to seek permission from the Iran-backed government in Baghdad before taking action.

Finally, in a story that has evaded headlines, Iran’s Oil Ministry is suing the privately owned Turkish airline Onur Air, claiming that the company is a hidden asset of alleged sanctions-busters. This is the first Iranian lawsuit against a Turkish company in history, and is even more significant considering that Onur Air is Turkey’s largest private airline.

Despite all of this, with the end of international sanctions, the economic ties between Iran and Turkey are likely to expand. Turkey is keen to cash in, and so is Iran, despite their lingering differences. The key to long-term prosperity for these two unlikely partners will hinge on Iran’s readiness to implement economic reform and its willingness to abide by the constraints of the nuclear deal that makes all of this possible. Neither are guaranteed.

Summary

In this article, we look at the impact the implementation of the Joint Comprehensive Plan of Action (JCPOA), agreed to by Iran and the P5+1 (the five permanent members of the UN Security Council – China, France, Russia, the UK, and the U.S. – plus Germany) could have on the trade and financial flows between Iran and one of its most important trading partners, Turkey.

- We expect a modest rise in foreign direct investment (FDI) along with an increase in bilateral trade. Real estate will be the main sector to benefit from Iranian investment in Turkey, while the Iranian technology and manufacturing sectors are likely to benefit significantly from Turkish investment.
- Given the downside pressure from increased volumes, Turkey is likely to benefit from lower imported energy costs in the short term, while Iran’s energy exports are expected to remain below historical peaks for the next few years as investment deals only slowly pick up.
- Cross-border portfolio investment and banking sector links will likely remain low given the low levels of financial depth in both countries.
- In the medium term, we expect increased competition between Iran and Turkey for foreign capital, particularly long-term investment, as both are populous countries with the capacity to absorb investment.
- Although energy sector cooperation and investment may increase if the effects of sanctions relief are felt quickly, it will be limited by market concerns about the risk of renewed sanctions.
- Under a downside scenario, where the effects of sanctions relief are delayed or where relief is reversed for any reason, we would expect the situation to return to the static pre-deal state.

Positive Impact of the Nuclear Deal on Iran’s Economy Will Be Driven by Sanctions Relief

Iran has faced international sanctions in some form since the revolution of 1979. Since then, and especially after 2006, the scope and severity of sanctions have steadily increased. Sanctions pressure reached its peak in 2011-12 when the U.S. and the EU worked to cut Iran off from the global financial system and sharply reduce energy exports. The U.S. placed sanctions on all financial transactions with Iranian banks, including the Central Bank of Iran, making exceptions only for selected crude oil sales to six Asian trading partners (China, India, Japan, South Korea, Taiwan, and Turkey) if these countries showed a “significant” reduction in crude oil purchases over time. Meanwhile, the EU instituted its own Iranian oil embargo and (under U.S. congressional pressure) disconnected designated Iranian banks from the global financial messaging mechanisms operated by the Society for Worldwide Interbank Telecommunication, or SWIFT. This latter measure effectively prevented Iran from conducting most formal international financial transactions.

Under the terms of the JCPOA, many of these sanctions were lifted on January 16, 2016 (“Implementation Day”) after the International Atomic Energy Agency (IAEA) verified that Iran had implemented its initial nuclear commitments. The reconnection of Iranian banks to SWIFT, expected within a matter of weeks, is likely to represent the most important development for Iran’s future trade and economic prospects. Energy-related sanctions were also suspended, allowing Iran to resume energy exports and eventually to attract new energy buyers. Roubini assumes that Iran’s oil exports will increase by around 500,000 to 800,000 barrels per day by the end of 2016.

However, the oversupplied global oil market suggests Iran will face strong competition (which will keep global prices weak), while the lack of investment since 2010 suggests that production will stall at around 4 million barrels per day. As such, greater investment will be required to increase production levels, while meaningful increases in energy production will require new servicing contracts and will likely impact supply only in 2020 and beyond.

The U.S. also agreed to suspend its secondary sanctions – those prohibiting other countries from doing business with Iran – especially in the energy trade. On October 18, 2015, known as “Adoption Day,” U.S. President Barack Obama issued the necessary waivers that came into effect on Implementation Day; significant other UN- and EU-imposed sanctions were also terminated or suspended on the same date, while others will be suspended at subsequent intervals over coming years if the nuclear agreement remains on track. UN sanctions on conventional arms will lapse in five years, and ballistic missile restrictions and other U.S. and EU sanctions will terminate in eight.

Direct, or primary, U.S. sanctions will remain on the books, as will other secondary sanctions pertaining to Iran’s support for terrorism and human rights abuses. These non-nuclear sanctions are unaffected by the JCPOA, but will have little impact on the financial relationship between Turkey and Iran.

**Part 1. Goods Trade: Benefits to Turkey in the Short Term, Iran in the Longer Term**

Unsurprisingly, given their proximity, trade between Turkey and Iran is well-developed. However, Turkey is a much more significant trading partner for Iran than vice versa, in part due to historical obstacles to Iran’s global trade. Figure 1 below shows Iran’s ten largest trading partners in 2014, as measured by the total value of two-way trade (exports plus imports). With approximately $14 billion in two-way trade in 2014 ($10 billion of exports to, and $4 billion of imports from), Turkey is Iran’s third-largest trading partner, behind only China and India. Bilateral trade represents around 10 percent of Iran’s total trade.

**Figure 1: Iran’s Largest Trading Partners Include China, India, and Turkey in 2014 (Total Value – U.S. Billion Dollars)**

![Figure 1: Iran’s Largest Trading Partners Include China, India, and Turkey in 2014 (Total Value – U.S. Billion Dollars)](chart)

*Source: UN Comtrade Database, Roubini Global Economics*
We can see in Figure 2 that Iran is only Turkey’s eighth-largest overall trade partner (and only its tenth-largest export market). The $14 billion in two-way trade represents only three percent of Turkey’s total trade. In part, this stems from the drop in dollar values for Turkish imports from Iran, which have been restrained by lower global prices for energy.

Turkey’s trading relationships are also far more diversified than Iran’s. Whereas just two countries (China and India) are responsible for more than 50 percent of Iran’s total two-way trade, Turkey has eight key trading partners. This is unsurprising considering Iran’s international pre-JCPOA isolation, which left it with far fewer options from which to source imports and send exports.\(^{12}\)

**Figure 2: Iran is Turkey’s 8th Largest Trading Partner (Total Trade Value 2014 — U.S. Billion Dollars)**

![Chart showing Iran's trade partners](chart)

*Source: UN Comtrade Database, Roubini Global Economics*

**Iran’s Exports Are Primarily Energy**

Iran’s exports are also much less diversified than Turkey’s, and heavily concentrated on energy (see Figure 3). Trade flowing from Iran to Turkey (i.e., Iranian exports or Turkish imports) is overwhelmingly dominated by energy, with mineral fuels, oil, and their products accounting for more than 85 percent of the total trade value. This is not unique to Turkey; energy dominates Iranian exports to all its other major partners as most of its domestically-produced manufactured goods are consumed at home.

\(^{12}\) Of Iran’s major import partners, five were countries that continued to buy Iran’s oil (China, India, Japan, South Korea, and Turkey), while sanctions regulations transferred proceeds to escrow accounts in those countries. The funds in the accounts could only be used to buy humanitarian and non-sanctioned goods from those countries.
Figure 3: Iran Exports Mostly Energy (Percentage, 2014)

Source: UN Comtrade Database, Roubini Global Economics

Figure 4: Turkey's Exports to Iran Are Diversified (Percentage, 2014)

Source: UN Comtrade Database, Roubini Global Economics
**Trade Has Been on a Moderate Uptrend**

Meanwhile, Turkish exports to Iran are far more diversified, with no single category making up more than one-quarter of the total value. Most of the largest categories, in terms of total trade value, are either parts or components for industrial machinery; materials such as metals, plastics, fertilizers, and wood; or consumables such as tobacco, pharmaceuticals, and vehicles. Most of these imports support Iran’s domestic industrial sectors, such as auto makers.

To assess the likely impact that the easing of sanctions will have on trade between Turkey and Iran, we looked at the historical data to identify long-term trends, while also looking at the impact of tightening sanctions, beginning in 2011. Figure 5 plots the value of Iran’s exports to Turkey as a percentage of Iranian GDP between the years 2000 and 2014. Turkey’s relative importance has grown, albeit in fits and starts, since 2000.

**Figure 5: Iranian Exports to Turkey Scaled by Iranian GDP — Upward Trend with Recent Softening**

This upward trend was punctuated by a sharp one-year slump in 2009 – due to the global financial crisis and sharp drop in oil prices – but resumed as Turkey remained one of the six countries that received waivers for energy trade with Iran. Under this arrangement, Turkey was permitted to continue purchasing Iran’s oil, albeit at lower volumes than in the past. Trade volumes seem to have softened in 2014 from the previous year’s peak, but it is difficult to draw firm conclusions about whether this is related to sanctions, the oil price collapse, or the slowing of Turkish growth.

*Source: UN Comtrade Database, Roubini Global Economics*
Figure 6: Turkish Exports to Iran Spiked in 2012 (Exports to Iran as Percentage of Turkish GDP)

Source: UN Comtrade Database, Roubini Global Economics

With the exception of a spike in gold exports in 2012, Turkish exports to Iran have been a modest contribution to Turkey’s economy. This huge increase in gold flowing from Turkey to Iran was probably the result of an alleged “gas-for-gold” sanctions-busting scheme that the Turkish authorities facilitated, in part, to improve the country’s trade balance, coinciding with a period of record demand for Iran as inflation spiked and consumers sought a store of value. The scheme yielded Iran some $13 billion in Turkish gold (directly and via the UAE) between 2012 and 2013 before U.S. measures shut the loophole.\(^\text{13}\)

Turkey doesn’t produce gold in large quantities, and therefore any gold exports from Turkey require corresponding imports from other countries, meaning the net effect on Turkey’s economy was modest. There are several reasons that suggest Iranian buyers will remain less interested in gold, including the tight monetary policy in Iran (which reduces the need for a store of value), the recent price correction in gold (which raises questions about whether it will maintain value), the challenge of converting gold into liquid hard currency, and attractive pricing for other domestic assets (including the stock markets, government bonds, and possibly even housing). Indeed, even after the precious metals trade was selectively allowed in the JCPOA, sanctions relief gold import volumes were low. Given this, and the fact that the net effect on Turkey’s economy is low, we excluded it from our forward-looking analysis. Removing gold from the historical trade numbers (see Figure 7) reveals a smoother upward trend in exports from Turkey to Iran that actually peaked in 2011, dropped sharply for two years, and then rebounded in 2014, along with a broader increase in Iranian imports from a range of countries, including China.\(^\text{14}\)


The reduction in the relative value of Turkish exports to Iran from 2011 (in USD terms), and in particular the drop from 2012 to 2013, corresponds with the coincident increase in the severity of sanctions. The modest sanctions relief in 2014 corresponds to the increase in both Iranian GDP growth and Turkish exports to Iran. After flat lining in 2015 due to weaker oil prices, it is likely that the easing of sanctions as a result of the JCPOA will allow the longer-term upward trend to resume.

**Trade Is Becoming More Diversified**

Looking at the historical composition of trade (see Figure 8), we find that the proportion of Iranian energy sector exports to Turkey has actually decreased over the past decade, in both volume and price. Mineral fuels, oils, and their products accounted for approximately 96 percent of the total value of all Iranian exports to Turkey in 2005. Since then, plastics (in which petroleum is a key input) has increased from around one percent of the total to five percent, while copper has increased from less than half a percent to more than two percent. Nevertheless, oil and electricity still dominate.

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**Figure 8: Iran Mostly Exports Energy to Turkey, Although Diversification Is Increasing (Percentage of total trade value)**

![Graph showing Iran's trade diversification](image)

*Source: UN Comtrade Database, Roubini Global Economics*

**Figure 9: Turkey’s Main Sources of Mineral Fuel and Oil Imports, 2007 and 2014 (U.S. Billion Dollars)**

![Graph showing Turkey's import sources](image)

*Source: UN Comtrade Database, Roubini Global Economics*
Iran is one of Turkey’s largest suppliers of energy products, and the total trade value of these products has actually increased over the past seven years. According to figures reported to the UN’s Commodity Trade Statistics Database by Turkey’s National Statistical Office, the largest increase of energy imports between 2007 and 2014 comes from “areas not elsewhere specified” – likely oil imports via the pipeline from Kurdistan/Northern Iraq.

Since 2011, there has been a steady decline in Iran’s share of Turkey’s total fuel and oil imports, largely due to sanctions, which prompted diversification. Figure 10 plots the total value of Turkish oil imports from Iran as a percentage of the value of Turkey’s global oil imports.

Looking at the ten largest components of trade from Turkey to Iran (excluding gold), there has been some volatility, but the relative shares are more or less the same as they were ten years ago. This implies that sanctions have actually had relatively little impact on the composition of Turkish trade to Iran. Most of the sectoral goods Turkey supplies to Iran were not a specific target of sanctions, although the blow to trade-related flows and Iranian income weakened import capabilities.

**Figure 10: Iranian Oil Exports to Turkey Are Volatile (Percentage of Total Trade Value of Turkish Oil Imports)**

*Source: UN Comtrade Database, Roubini Global Economics*
In the Short Term, Turkey Is Likely to Benefit More Than Iran

Because Turkish exports to Iran are far more diverse than Iran’s exports to Turkey, as the sanctions are suspended and the Iranian economy begins to grow, it is likely that Turkish exports will grow along with it.

We anticipate the value of services exports from Turkey to Iran will increase. In particular, given the high tourist inflows from Iran, tourism is likely to benefit the most from the deal. Meanwhile, the suspension of sanctions is unlikely to alter the composition of Turkey’s imports from Iran, which are mostly commodity based. As Iran’s oil exports to Turkey were only partly hit during the sanctions period, only a modest increase in export volumes is expected, unless Iran begins discounting heavily. To see significant gains from trade, Iran would probably need Turkey’s economy to grow at much higher rates than it is currently, and hence see its energy demand increase, but this is unlikely in the short term. Alternatively, Iran would need to displace some of Turkey’s other suppliers of energy, such as Russia. Recent tension between Ankara and Moscow makes this more likely. A key catalyst for Iran increasing its market share in Turkey would be an increase in the price Russia charges Turkey for oil and gas, or any unforeseen disruption in supply.

In the Medium Term, Iran Could Be a Net Beneficiary

Assuming that Iran implements some liberal economic reforms (as Rouhani’s government has been signaling) and moves to further diversify away from oil, it could begin to develop a competitive advantage over Turkey in certain sectors, while also attracting more energy investment from international oil companies (IOCs). Combined with cheaper labor and a currency that has adjusted to its weaker terms of trade, this could boost non-energy exports to...
Turkey. Put simply, an increasingly competitive Iranian economy could lead to Iran replacing some European and Asian products in the Turkish markets, although it would take some time before Iran could compete on quality. The sectors that could benefit include medium- to high-technology goods that Iran has been forced to produce on its own due to sanctions. Among these are nuclear reactors, airplane parts (despite their poor quality), medicine, plastics, petrochemicals, and even automobiles.

The medium-term view, however, depends largely on how Iran’s leaders manage the economy, what terms are offered to foreign oil investors, whether Tehran is able to attract significant quantities of foreign investment, and what (if any) structural changes occur. If Iran elects to maintain the status quo, fails to liberalize its economy, or vested interests like the IRGC block growth-enhancing reforms, the short-term impact may not be significantly different than the medium-term impact, whereby Iran benefits from trade with Turkey only if Turkey’s energy demand grows.

**Energy Exports Long Term: Watch Natural Gas**

Iran and Turkey could also sign a number of trade agreements that would see trade volumes increase significantly. These agreements could include, inter alia, the building of additional pipelines. Currently, there is only one natural gas pipeline that connects Tabriz to Ankara, at 14 billion cubic meters (bcm) per year. The Iranian and Turkish governments have previously discussed building a “Persian Pipeline” (30-40 bcm per year) to transport Iranian natural gas through Turkey to Southern Europe. Iran’s re-engagement with the West could jumpstart this. Both of these projects would yield short- and medium-term gains for the Turkish economy, mainly through cheaper gas imports and increasing infrastructure investments. It would also help Turkey diversify its energy partners, which would be a welcome move in light of the recent standoff between Turkey and Russia, from which Turkey receives nearly one-third of its energy supply.

From Europe’s perspective, the pipeline project makes good sense. Spurred by the crisis in Ukraine, European countries are determined to diversify their natural gas suppliers away from Russia. Iran has enough reserves to cover all of Europe’s needs for the next century, and it is viewed (rightly or wrongly) as coming under Western influence. The EU also has the advantage of using a member candidate country – Turkey – as a middleman, hence minimizing its direct relations with Iran during the delicate post-sanctions period.

Yet, there are a number of factors that could delay the project. First, Iran barely produces enough natural gas for its own domestic demand, while also exporting gas to different buyers pursuant to deals with Oman and Iraq. Moreover, Iran’s buyback scheme (a short-term buyback agreement between the National Iranian Oil Company and any IOC for petroleum exploration where the IOC never gains equity rights in the oil and is awarded in cash after completion of the project) for extracting energy resources limits the willingness of foreign energy companies to invest for the long term in Iran, thereby reducing the efficiency of the sector. Sanctions also limited Iranian oil companies’ ability to access finance and equipment for upgrading infrastructure, exacerbating the poor performance.

Iran’s first step after the suspension of sanctions is likely to be investing in infrastructure to jumpstart natural gas production rather than oil. Iran’s government is reportedly set to introduce new plans that seem to be more attractive, although the details are still sparse. It is not clear, however, that the government is interested in exporting much excess production. It is more than likely that the increased gas supply will be used to boost oil production with cheap energy helping to build new infrastructure domestically.

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Moreover, even if natural gas production exceeds expectations, the excess is more likely to be exported to Asia or the Middle East rather than to Europe. Iran does not yet have built-in infrastructure with either Asia or Europe and is still building pipelines to some possible destinations. Given its location and ability to accept liquefied natural gas (LNG), Asia is better suited than Europe to receiving LNG exports from Iran. It is also worth noting that the leaders of Iran and Pakistan are fully committed to the announced pipeline slated to supply Pakistan and India, and possibly even China, with Iranian natural gas, although financial issues remain. A similar pipeline to Europe through Turkey poses many political and financial hurdles.

Turkey gets roughly 30 percent of its natural gas supply from Iran, with the rest divided between Russia and Azerbaijan. Even if Iranian gas becomes more competitive thanks to increased investment in the sector, Turkey’s historical ties with Azerbaijan would make it politically difficult to substitute Azeri gas with Iranian gas. However, the net result would probably imply a reduction of spot natural gas prices in the region.

Meanwhile, Russian gas will likely remain significantly cheaper for Turkey than Iranian gas for two reasons. First, there is already built-in infrastructure. Moreover, Gazprom, a Russian company, gives the Turkish natural gas monopoly, BOTAS, handsome discounts on its gas. Despite recent tension between Turkey and Russia, none of the sanctions announced by the latter have related to the energy sector, and such sanctions are unlikely to be imposed without a serious escalation of the dispute. Thus, Iranian gas is unlikely to replace other producers in the Turkish market in the near term, but it could be more meaningful for Asia and parts of the Middle East.

Last but not least, if Western powers continue to increase engagement with Iran after the implementation of the nuclear deal, there could be a spike in foreign investment in Iran’s oil exporting capabilities, which would benefit Turkey through lower import costs. Initially, Iran will work to rebuild its previous production levels, while new investment will likely begin adding capacity, starting around 2020. Currently, there are no oil pipelines that connect Turkey and Iran, but improving relations between the two countries could eventually change this.

Part 2. Services Trade: Iranian Tourism Is Likely to Make Modest Gains in Turkey

Iran and Turkey have had visa-free travel since 2008, which has helped the Turkish tourism industry immensely. Roughly 1.5 million Iranian tourists travel to Turkey each year, and the share of Iranian tourists in Turkey’s total has been steadily increasing in recent years. We estimate Turkey’s revenues from Iranian tourism to be around $5 billion per year. Unlike outbound tourism from Europe, which peaks in the summer months, Iranian outbound tourism is not particularly seasonal. It tends to be dispersed almost equally throughout the year. This is partially due to Iranian demand for health tourism, as well as bargain hunting.

The increasing of sanctions pressure on Iran after 2011 had a relatively limited and indirect impact on the tourism industry in Turkey. The devaluation of the Iranian Rial led to a loss of purchasing power vis-à-vis the Turkish Lira, while Iran’s recession led to lower wages and a contraction of credit. Moreover, Iranian nationals reported difficulties in accessing their offshore assets in Turkey. Nevertheless, tourism to Turkey from Iran has continued to increase year-over-year, even as the global financial crisis and tightening of sanctions slowed the growth rate of tourists coming from Iran. We expect growth in total tourist numbers to continue, particularly as Turkey has become more competitive relative to other destinations. Improving economic prospects in Iran could eventually push tourism higher. However, a significant rise in incomes could prompt Iranians to choose Europe or Asia over Turkey, particularly if the Euro remains weak relative to the U.S. dollar.
**Figure 12: IRR Devaluation Led to Decline in Purchasing Power**

![Graph showing official and parallel market TRY/IRR from Jan-07 to Apr-15.](image)

*Source: Roubini Global Economics, Haver*

**Figure 13: Iran is Turkey’s Sixth Largest Source of Tourists, Likely in Top Three by Total Revenue (Percentage of Total Tourists)**

![Bar chart showing tourist revenue sources from 2013 to 2015.](image)

*Data up until September*

*Source: Turkish Ministry of Tourism*
In the medium term, inflows of tourists to Turkey from Iran are likely to plateau in 5-10 years. Iranians are likely to travel to other destinations in Europe and Asia as income per capita grows and their ability to transfer funds increases. An improvement in Iran’s domestic health services is also likely to lead to a decline in tourism to Turkey.

As for tourist flows from Turkey to Iran, we expect very little change. The impact of sanctions relief is unlikely to have a significant impact on the attractiveness of Iran as a tourist destination. Any increase is likely to come from business travelers, but this segment represents a relatively small proportion of the overall tourist numbers.

**PART 3. FINANCIAL LINKS: LIKELY TO REMAIN SMALL IN THE SHORT TERM**

Despite being large trade partners, there are relatively few cross-border portfolio investment and banking sector linkages between Iran and Turkey. The trade between the two is largely denominated in U.S. dollars (and to a lesser extent, Euros), and there is often a third party involved in the cross-border transactions between the two countries. There is only one Iranian bank operating in Turkey – Bank Mellat – but even that bank accounts for less than 0.1 percent of the total banking assets in Turkey. A second bank – Bank Saman – recently applied for a banking license, but the decision is only expected to be announced in early 2016.18 There are no Turkish banks operating in Iran due to Iranian regulations that restrict private, foreign banks. Of the Turkish banks, the state-owned Halk Bank and Ziraat Bankasi (the largest lender in Turkey) are both heavily involved in transactions in Iran, mainly related to financing the government’s natural gas and oil purchases. These legal trades may have been abused for illegal transactions.19

In the medium term, Turkish banks may seek to open branches in Iran (as they did in the EU, Dubai, Egypt, etc.), but we are unlikely to see a significant Turkish presence in Iran’s banking sector due to the latter’s autarchic nature, insolvency issues, and reputation for money laundering. Iranian banks are likely to want to increase their presence in the Turkish market, as the Bank Saman example shows. However, the Turkish banking watchdog, the Banking Regulation and Supervision Agency, has been very conservative in distributing new licenses due to the increasing number of small banks operating in Turkey, which is weighing on the overall profitability of the sector and adding to re-financing risks, as well as creating additional concerns about counterparty risk. Iran's banking system may thus need to undergo a meaningful restructuring and recapitalization, as an increase in non-performing assets could result in the imposition of regulations that are not supportive of foreign bank entry.

We expect formal portfolio capital flows between the two countries to increase from the very modest base. With the suspension of sanctions, savings that are currently captive in Iran could be invested in Turkey, which would have a mild positive impact on portfolio inflows. There is plenty of anecdotal evidence of Iranians smuggling cash into Turkey, which is recorded in the “net errors and omissions” line in Turkey’s balance of payments. Recently, this item has risen dramatically (see Figure 14), although we doubt trade with Iran is the only explanation. Some of the inflow could also be explained as capital fleeing Russia, Ukraine, Iraq, and Syria. Additional funds are also likely to arrive through more formal channels. Given the conservative (or rather domestic) nature of Turkish investors and the small amount of savings in Turkey, we do not expect to see any major pick up in portfolio inflows to Iran from Turkey.

18. Bank Tejarat and Pasargad Bank are also expected to reapply to be involved in the Turkish finance market if Bank Saman’s application is approved.
19. For an example of how the legal trade may have been a cover for corruption and illegal trade, see Jonathan Schanzer and Emanuele Ottolenghi, “Turkey’s Teflon Don,” Foreign Policy, March 31, 2014. (http://foreignpolicy.com/2014/03/31/turkeys-teflon-don/)
In the medium term, portfolio investment between the two countries is likely to remain modest. Portfolio flows between emerging market economies are rare given the preference to diversify portfolios. Furthermore, Turkey has relatively little in the way of savings (15 percent of GDP compared with 32 percent in Iran) to invest abroad and household savings are even lower. In Iran, given low financial literacy, savings tend to be more geared toward FDI (particularly property) than anything else.

**Part 4. Direct Investment Likely to Pick Up**

There has been significantly more FDI from Turkey into Iran than vice versa, reflecting the differing structure of investments between the two countries. Although FDI from Iran to Turkey comes mostly from individuals investing in the real estate sector, the reverse is mostly from companies investing in the industrial sector and small businesses. We expect this trend to continue and even intensify in the near term. With the lifting of SWIFT restrictions, it will be easier for Iranians to transfer money into Turkey to purchase houses. Meanwhile, Turkish companies (especially in the construction sector) are likely to invest in Iran’s large economy to benefit from its high domestic demand and young population, as they have done in other Middle Eastern economies.

In the medium term, bilateral investment should increase, but is likely to be dwarfed by investment from third countries. Both countries are also likely to compete with each other for FDI from developed economies and big emerging market corporates.

Iran and Turkey have similar demographics; Iran’s population is 77 million compared with Turkey’s 76 million. Age distribution is similar, with nearly 50 percent of both populations under 30 years old, although both struggle to deploy this labor due to human capital restrictions. The two countries share similar levels of geopolitical importance, with proximity to key markets (Turkey to the EU, Iran to Asia). Turkey’s economy is close to twice the size of Iran’s, but it is stuck in a middle-income trap and its GDP growth rate has fallen significantly (albeit from a higher base), while Iran’s growth rate is set to increase. From a domestic demand (population) and export demand (location) perspective, both countries are well-situated to receive FDI from developed countries.
There are a number of aspects, however, where Iran looks more attractive than Turkey as an investment destination. First, labor is significantly cheaper. The minimum wage in Iran is close to $240 per month, while it is almost twice that, at $453, in Turkey. Iran is also the fifth-ranked country in terms of the total number of computer scientists. Unlike Iran, Turkey already has sizeable external debt levels and has a lower ability to adjust fiscal policy. With 92 percent banking penetration (compared with 60 percent in Turkey), the financial sector plays a more significant role in Iran than Turkey, making it an ideal candidate for innovative IT investments. High levels of non-performing assets remain an issue. Furthermore, Iran has a sounder macroeconomic environment, with a similar level of hard infrastructure compared with that of Turkey (based on the World Economic Forum’s competitiveness rankings). Last but not least, Iran’s access to cheap energy stands out as a particularly important advantage over Turkey. Iran’s ability to benefit from this will depend greatly on domestic and international policy implementation, including how the continued presence of the IRGC in the economy influences investment prospects, and how much resistance is put up by the hardcore revolutionaries in the government.

Although the gap is closing, Turkey still scores better than Iran on Roubini’s Country Insights Investment Attractiveness Index (see Figure 15). This is because Turkey performs better on a number of efficiency-enhancing issues, such as goods and labor market efficiencies, financial market development, and business sophistication. It also performs significantly better on the ease of doing business index. Indeed, Turkey is superior on all fronts, from getting licenses to starting a business to paying taxes. Iran has also been designated as a sponsor of terrorism by the U.S. State Department, increasing the risk of further sanctions being imposed, and acting as an obstacle to long-term investment.

**Figure 15: Turkey Still Ahead, But the Gap Is Closing (Roubini Investment Attractiveness Index: 10 = More Attractive)**

![Graph showing Turkey and Iran's investment attractiveness index from 2005 to 2015](image)

Source: Roubini Global Economics Country Insights

This suggests Turkey is currently a better candidate for FDI, but if Iran starts to undertake efficiency-enhancing reforms, it could compete in the future. Uncertainty over the implementation of sanctions and potential obstacles from vested interests that might not welcome global competition (such as the Revolutionary Guards, the business
community, the government, etc.) may delay investment and could add to volatility. The persistence of non-nuclear sanctions will continue to make investing more difficult. Moreover, domestic capital markets cannot support extensive financial investment. This suggests that any increase in investment could be slow unless the government immediately starts implementing serious reforms, which is quite unlikely.

**PART 5: UPSIDE AND DOWNSIDE OF THE LONG-TERM VIEW**

There are a number of potential upside and downside possibilities to the analysis presented above.

**Upside:** In one upside scenario, the impact of sanctions relief on trade and business ties would increase and/or occur faster than expected, or pro-market reforms would be implemented more rapidly. Thus, along with Iran's re-inclusion in SWIFT, which reduces transaction costs on trade, the EU would begin importing energy from Iran immediately. A further source of upside would be if Iranian official foreign assets are not only unfrozen, but prove to be more sizeable than the $20 billion that U.S. and Iranian officials have suggested.20

Meanwhile, relations between the U.S., the EU, and Iran could improve to the extent that Iran is seen as an ally along with Turkey. In this event, Iran's oil production would increase quickly due to easier access to financing and new investment (as a result of attractive terms) over the next several years. A clear set of oil and gas contracts would be a key precondition for this. Given the additional supply on the market, oil and natural gas exports and investment would pick up. Overall industrial demand would be a meaningful driver.

**Downside:** If, despite the suspension of sanctions, international companies are hesitant about engaging in business with Iran over concerns about remaining sanctions, or if Iran is unwilling to make reforms to better absorb foreign capital, or if those with vested interests (such as the IRGC) block investment, Iran's trade and financial situation will not improve significantly. Oil output would remain roughly unchanged.

The downside scenario is likely to negatively impact both Iran and Turkey, to differing degrees. We expect the Iranian economy to suffer from negative sentiment and the re-imposition of sanctions in response to Iranian non-compliance with the deal, or other actions that violate it – for example, the UN Security Council's ban on Iranian ballistic missile development. This could send the economy back into recession. Since the announcement of the deal, the Iranian rial and the stock market have both stabilized (see Figure 16), although economic activity has been sluggish due to the weak oil prices. If the deal is suspended due to Iranian violations, investments will be on hold and Iranian consumption would likely wane again. Indeed, Iran's degrading infrastructure, and its inability to access external finance to upgrade it, would again put pressure on the Iranian government to halt its nuclear ambitions in exchange for sanctions relief.

Under this scenario, oil markets would probably tighten (and prices rise) due to lower expected output from Iran. Given Turkey's dependence on imported oil, its current account deficit would increase from the current 4-5 percent of GDP pace, further exposing Turkey's external weaknesses and leaving it more exposed to external shocks. In the medium term, the delaying of sanctions relief would mean lost opportunities, but it would limit Turkey's potential growth rather than decrease it.

**Figure 16: Iranian Rial and Stock Market Have Stabilized Since Nuclear Deal’s Announcement**

Source: Roubini Global Economics, Haver

**Figure 17: Turkish Exports to Iran Are Also Correlated With Iranian GDP**

Source: UN Comtrade Database, Roubini Global Economics
As Figure 17 shows, Iranian imports from Turkey (Turkish exports) tend to correlate with Iranian GDP growth. Thus, higher growth in Iran as a result of the suspension of sanctions is expected to positively impact Turkish exports and GDP.

In summary, in the baseline scenario of energy and financial sanctions relief, the ties between Iran and Turkey are likely to grow rapidly. The impact will be asymmetrical, with Iran benefiting more from Turkey than vice versa, given its more closed economy. Turkish exports to Iran will likely remain concentrated on industrial and commercial products and services including tourism, while we see energy dominating Iranian exports. Cross-border portfolio investment and banking sector links are likely to remain modest, impaired by the need to recapitalize Iran's banking system. Over time, bilateral direct investment, too, should increase. Assuming that the Iranian government implements reforms and is able to facilitate a more consistent business environment, it could eventually compete with Turkey for FDI in some areas.
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