

April 13, 2015

The Iran Framework

On April 2, the P5+1¹ negotiating team and Iran announced a framework to deal with Iran's nuclear program. The framework is a "roadmap" to establishing a final agreement in June. Negotiations on this issue have been underway for years; this framework could be a major step toward delaying Iran's entry into the "nuclear club," the group of nations that have nuclear weapons.

In this report, we will begin with a short history of Iran's nuclear program. Next, we will review the details of the framework. The third part will address the broader policy issues surrounding Iran's nuclear program. An analysis of the real issue, regional hegemony, will follow along with a review of the political factors of the deal. We will conclude with the potential market effects from this framework.

The History

Iran began to build a nuclear power industry in the 1950s as part of Eisenhower's "Atoms for Peace" program. By the late 1960s, it had a small research reactor, fueled with highly enriched uranium. In the 1970s, the Shah wanted to build 23 nuclear power plants to allow Iran to export more oil. U.S. and European firms vied for Iran's business. President Ford offered to build Iran a reprocessing facility that would have allowed Iran to extract plutonium, which

¹ P5+1 includes the U.S., U.K., France, Russia and China (the five permanent members of the U.N. Security Council), plus Germany.

would have created a clear path for Iran to develop nuclear weapons.

After the 1979 Iranian Revolution, foreign cooperation with Iran's nuclear industry ground to a halt. Although Ayatollah Khomeini opposed nuclear weapons on theological grounds, Iran resumed nuclear research in 1981. The U.S. effectively prevented Iran from acquiring materials or support for its nuclear industry by applying diplomatic pressure. Still, in 1984, West German intelligence warned that if Iran was able to procure enriched uranium from Pakistan, then "it might be two years away from a bomb."² In the 1990s, Iran continued to develop its nuclear industry, although the U.S. was able to convince some nations to cancel investments to slow Iran's progress. Russia did provide support for the Bushehr nuclear power plant during the decade.

During the 2000-2009 period, two secret nuclear sites were revealed through information passed to the West from Iranian dissident groups. This discovery led to calls for additional International Atomic Energy Agency (IAEA) inspections. Negotiations between various parties, including the E.U. and the U.N., were ongoing through the decade. Iran has added centrifuges to enrich uranium over the past 25 years, increasing from around 100 to nearly 20,000.

² Anthony H. Cordesman, "Iran and Nuclear Weapons: A Working Draft," Center for Strategic and International Studies, 7 February 2000; "Iran Atomic Energy Agency Head Goes to Bushehr," BBC Summary of World Broadcasts, 24 June 1989. It should be noted that this claim has persisted for most of the past three decades; to date, there isn't any evidence that Iran has actually developed a weapon.

In response to Iran's expansion of its nuclear facilities, the West has steadily increased pressure on the regime. Sanctions have been steadily expanded.³ The U.S. has used cyber-warfare against Iran's nuclear facilities.⁴ Iran has maintained that its nuclear program is for peaceful purposes; the West disagrees and worries that Iran is attempting to build nuclear weapons.

Over the past two decades, three presidents have indicated that an Iranian nuclear weapon was intolerable and that the U.S. would not hesitate to use military means to prevent that outcome from occurring. The best way to guarantee that Iran's nuclear program does not make that step would be to prevent uranium enrichment.

Candidate Obama indicated he would break the deadlock by offering to negotiate with Iran. Although talks had been ongoing for some time, he promised to do more to bring a deal to fruition. Along with ending the Iraq War, Obama made improved relations with Iran a cornerstone of his foreign policy platform.

President Obama implemented a harsh sanctions regime on Iran. He also continued and expanded the cyber-warfare which began under President Bush. So, there has been a clear "carrot and stick" approach. Unlike his predecessors, Obama clearly wanted a change in relations with Iran. As we have noted before, the current president appeared to be seeking a "Nixon to China" moment with Iran.⁵ That position seems to be the administration's aim in current talks with Iran.

The Framework

The outline of the deal is as follows:

1. Iran will operate 5,060 of first generation centrifuges at Natanz, the only approved site for enrichment activities. It will not enrich uranium beyond the 3.67% level, which is well below the 90% required for weapons production.
2. The hardened facility at Fordow will be repurposed for nuclear research and isotope production.
3. The heavy water reactor at Arak will have its core reactor destroyed or removed, preventing it from producing plutonium.
4. Of the 10k kilograms of enriched uranium that Iran holds, 9.7k kilograms will be exported or diluted on site.
5. Iran agrees to an enhanced inspection regime from the IAEA.
6. The West agrees to lift or suspend sanctions.

There are details to work out, which will take place over the next three months. These details are not small issues. The two which will be the most problematic will be points five and six. Just how aggressively and openly the IAEA will be able to operate has not been resolved. Iran wants the West to remove sanctions immediately after a deal is concluded. That outcome isn't likely as sanctions are the only restraint on Iranian behavior; if Iran cheats, it will be very difficult to put sanctions back in place. A war will likely be the only way to prevent Iran from proceeding to build a nuclear weapon. So, the West needs to create conditions where sanctions relief is quick

³ See WGR, 3/5/2012, [Iran and S.W.I.F.T.](#)

⁴ See WGR, 10/4/2010, [The Stuxnet Virus.](#)

⁵ See WGR, 2/23/2015, [Détente with Iran: An Update.](#)

enough to act as a benefit to Iran to keep it compliant with the deal, and yet, at the same time, not ease them so fast that Iran feels it can stop cooperating.

The Nuclear Policy Issue

Ostensibly, the goal of negotiations with Iran is to prevent it from developing nuclear weapons. As noted above, for the past two decades, three American presidents have suggested that a nuclear armed Iran was intolerable; the best way to prevent that outcome was to not allow Iran to enrich uranium and the U.S. would be willing to use military means to prevent Iran from gaining such a weapon. Now, the goal has changed from preventing Iran from enriching uranium to allowing it to have nuclear capabilities just short of developing a weapon. What has changed?

First, the Obama administration has concluded that America has no appetite for another Middle East war. Attacking Iran would not be a cakewalk. The country is big; it has a large population that will be hostile, and a military well trained in asymmetric warfare. If the U.S. and its “coalition of the willing” struggled to pacify Iraq, Iran will be exponentially more difficult. Mere airstrikes, unless they are nuclear in nature, won’t end Iran’s nuclear program. In fact, once the bombing stops, one would expect Iran to move aggressively toward building a nuclear weapon.

Second, maintaining the current sanctions regime forever will be nearly impossible. Although sanctions have, to a great extent, become the weapon of first resort for the West, they rely on widespread compliance. Sanctions not only cause hardship to the target, but they have negative ramifications for trading partners. For example, the current sanctions on Russia have had just modest effects on the U.S., but the impact

on Europe’s economy has been significant. Thus, the longer the sanctions are in place and the more “collateral damage” they cause to those supporting the sanctions regime, the harder they are to maintain. In the case of Iran, sanctions have been very effective. However, expecting allies to maintain them indefinitely, or expand them further, may be folly. This is especially true if Iran agrees to what appears to be a reasonable program of nuclear restraint. If sanctions become unending or become more stringent, Iran may conclude that it might as well get a bomb because the West will never relent.

Third, President Obama has concluded that Iran sees its nuclear program as similar to the U.S. moon mission. The nuclear program is how Iran proves it is a modern nation. Asking Iran to end the nuclear program would have been similar to telling the U.S. in the 1960s to end the race to the moon. The president has decided that a more fruitful plan is to allow Iran to maintain a face-saving level of nuclear research and equipment and establish a “breakout threshold” of about a year. In other words, create conditions that would give the West about a year to react to Iranian actions that indicate a “race to the bomb.”

And so, President Obama has concluded that the most workable outcome is to accept that Iran will keep a reduced nuclear program that is under constant inspection rather than risk a war or rely on what will likely become an increasingly shaky sanctions regime. In return, Iran gets relaxed sanctions, which should boost its moribund economy.

The Real Issue

To some extent, when people face a very difficult problem, they will often focus on a lesser one rather than deal with the more important one. This process is similar to the psychological condition of transference.

Thus, the attention on the nuclear program hides the much bigger issue, regional hegemony.

Over the past four weeks, we have examined the “New World Order.” In that report, we concluded that the U.S. is trying to create a working model of maintaining hegemony on a sustainable level. This process hinges on shifting America’s focus to Asia and becoming a balancing power in the rest of the world. This means that the U.S. will reduce its projection of power in Europe, South America and the Middle East.

This process is fraught with risk. Since the collapse of the Ottoman Empire, Britain, France and the U.S. have dominated the Middle East region, preventing the local tribes and groups from creating natural nation-states and a workable balance of power. In fact, the colonial powers created national boundaries that were counterproductive to this process. The nations created by France and Britain were designed to allow for their management as colonies rather than for independence. Tribes and sects that should have been separated were put together and others that would have naturally gravitated together were prevented from doing so. Not only did this process assist the Europeans in controlling the region, but it allowed them to more easily exploit the area’s oil resources.

The U.S. did not engage in colonial dominance and mostly avoided self-determination, treating the colonial borders as sacrosanct. Thus, when Iraq invaded Kuwait in 1990, the U.S. built a coalition to force Iraqi troops out of the country. A reasonable argument could have been made, however, that Kuwait could have been part of Iraq.

Maintaining these less than ideal borders has been a costly exercise for the colonial powers and the U.S. as the region has required a persistent military presence.

For the U.S., it has meant involvement in several conflicts. The Nixon administration resupplied Israel during the Yom Kippur War, an act that triggered the Arab oil embargo which was a major cause of the 1973-75 recession. The U.S. suffered through the Hostage Crisis after the 1979 Iranian Revolution. The U.S. initially supported Iraq during the 1980-88 Iran-Iraq War, although it did provide assistance to Iran later in the conflict. The U.S. also reflagged oil tankers as American during the conflict to prevent either side from attacking oil shipping. The Bush administration built a large coalition and ousted Iraq from Kuwait during the Gulf War. It maintained a sanctions regime against Iraq until the 2003 Iraq War. American involvement in Iraq continued until 2011 when the last American soldier exited the country. The U.S. has returned to Iraq, providing air support against IS. The U.S. has also spearheaded the sanctions regime against Iran. It also participated in the air campaign against Moammar Gaddafi in Libya. This list is not exhaustive; but clearly, the U.S. has been involved in all sorts of conflicts and events in an attempt to manage the region.

It appears that President Obama has concluded that maintaining this level of involvement isn’t feasible and so, the creation of regional powers is necessary to stabilize the area. The U.S. won’t be able to completely abandon the area, but it won’t be the leading force of stabilization, either. Thus, the real reason for the nuclear deal with Iran is to allow this Shiite nation to develop into a major regional power.

The U.S. does not intend to make Iran the regional hegemon. The administration would like to see other powers coalesce to offset Iranian power. America will play a balancing role, becoming involved when one side becomes overly strong.

We are already seeing evidence of this evolution. The Saudi involvement in Yemen is a good example. Previously, the Saudis would have expected the U.S. to put a coalition together to stabilize Yemen. Now, the Saudis are leading the charge.

Needless to say, this position isn't going to be popular with our allies in the region. They have become accustomed to the U.S. providing a free public good to the Middle East in terms of security. The thought that they are going to have to take on this role themselves is new. It will force these nations to build larger militaries and expand their diplomatic corps. It is likely that more conflicts will occur.

These fears explain why Israel and Saudi Arabia have reacted so negatively to the possibility of a nuclear deal with Iran. The nuclear deal is something of a sideshow. Since the mid-1990s, Israeli PM Netanyahu has been warning that Iran is “two years away” from a bomb. To some extent, Iran knows that getting close to a bomb is problematic; in fact, having a bomb only means that one probably won't be invaded. Atomic weapons have mostly become the ultimate defense tactic. Instead, the regional powers want the U.S. to eliminate the revolutionary government in Iran so they won't have to live with it. The current framework signals that this hope is dashed.

Much could go wrong with this plan. There will be a struggle for hegemony, not just between Iran and the Sunni powers in the area, but also among the Sunni powers who

believe they should dominate. None of these powers is strong enough on its own to control the region; we would expect a shifting series of coalitions to be created. A glimpse of how this might work is probably reflected in how the U.S. is assisting Iran, the Kurds and Shiite groups against IS while assisting Egypt and Saudi Arabia against the Houthis, who are aligned with Iran, in Yemen.

If the framework evolves into a nuclear deal which signals détente between the U.S. and Iran, expect rising tensions in the region. We do expect the framework to end in a deal with Iran.

The Politics

In the U.S., there is virtually no constituency that supports Iran. This probably explains why the president has waited to press for a deal until he faces no further election. Congress will try to influence the talks; the House, which is controlled by the GOP, can easily pass legislation to establish obstacles to an agreement. However, the Senate will be another problem. Although the Republicans control the Senate as well, GOP leaders will have to convince some Democrats to vote against their president to override an inevitable veto, which requires 67 votes.

It should be noted that U.S. sanctions would be suspended but not ended. The president can suspend any sanction for a 120-day period and can repeat the process indefinitely. This fact also avoids needing Congress's approval to lift sanctions. Of course, the next president may decide to put the sanctions back in place. However, sanctions nearly two years later would be virtually unilateral, reducing their effectiveness. Thus, we would not expect the next president, regardless of party, to end the suspension process.

We would expect the GOP to use détente with Iran to characterize Democratic foreign policy as dangerously naïve. Most likely, the Democratic Party presidential nominee will be forced to run against this part of Obama's foreign policy. To some extent, a deal with Iran will help GOP candidates create a very useful issue to contest elections. In fact, an agreement with Iran may be more politically useful than preventing a deal. However, once an arrangement is in place, we doubt the next president will be able to rescind it. Thus, President Obama's foreign policy legacy, at least in terms of Iran, will probably remain in place.

Ramifications

If our view that the U.S. will reduce its attention to the Middle East is correct, we would expect the region to become increasingly unsettled. In the short run, the smoldering conflict between the Sunnis and the Shiites will likely be expressed by a

market share war between Iran and the Arab Gulf producers. Over time, however, we would expect a nearly constant war as colonial borders fade away and new proto-states, like IS, develop. This conflict will, at some point, lead to higher oil prices and increasing volatility.

The bigger issue is whether the policy change that President Obama is implementing is workable. Allowing the Middle East to work out new borders and a regional balance of power will be a messy affair and will attract outside powers to intervene to protect oil flows. It is understandable that the U.S. would like to deemphasize its role in the region; however, doing so may create a bigger crisis that will require even greater U.S. intervention in the future.

Bill O'Grady
April 13, 2015

This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.