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## Interviews

### *Iranian-American Relations Under The Early Obama Administration: Virtual Dialogue*

*What are the choices available to the Obama administration to deal effectively with Iran's nuclear policy?*

**Sick:** I have spelled out my own recommendations in an article that appeared in *The National Interest*, January-February 2009. These consist of clear positive signals from Washington, regional consultations on security issues, and pursuing the creation of a US-staffed interest section in Tehran, awaiting the completion of the Iranian presidential election in June.

**Amuzegar:** The first and easiest, but the most controversial, choice is to accept the status quo. That is to let Iran become a nuclear power, continue to make mischief in the region, and pretend to act as a regional bully as long as it can be "contained" and isolated – the way the Soviet Union was during the Cold War. This choice is based on the fatalistic assumption that there are no carrots or sticks that could dissuade Iran from acquiring nuclear weapons. Given Iran's existential threat to Israel and the objections of the Sunni Arab countries in the region and even of Russia, this defeatist choice is for all practical purposes not a realistic alternative.

The second option is the one proposed by American neo-conservatives and Israeli hawks: a "two-pronged" course of action that should include (a) further tough and iron-clad sanctions (including gasoline embargos and trade blockade), and (b) a readiness to use military force in the event that those sanctions do not succeed. The thinking behind this option is a faith-based conviction that only "regime change" can put an end to Iranian misbehavior, including its nuclear arms ambitions, and that a "surgical" military strike may do the job by mobilizing the Iranian masses to rise against the regime. To buttress the case for military intervention, it is argued that open-ended diplomatic negotiations would (a) simply enable Iran to buy more time to improve its ballistic missile capability in the service of its impending nuclear weapons; (b) legitimize Tehran as a principle player in Iraqi and Afghani affairs; and (c) be regarded by the mullahs as a sign of US weakness and desperation. The problem with this option, in the opinion of most experts, is that it would create more problems than it would solve.

The third option is constructive "engagement," ie tough and direct negotiations on all contentious issues in order to move past mutual mistrust and reach a grand bargain. Accordingly, the policy of antagonizing, isolating, and containing Iran would be replaced by selective political engagement and open dialogue with Tehran on all specific issues of "mutual concern" without the real or implied threat of military action. The problem with this option is that its proponents cannot

agree on how to go about it. Some believe that the process should start with contacts between lower level officials and concentrate on educational, cultural and sports exchanges. Others reject small, tactical and 'confidence-building' measures and advocate a grand bargain in which all outstanding issues are discussed at high level. Some believe that initial contacts between the two countries should be open; others believe they should be secret. Some argue that the approach should target Iran's supreme leader, Ayatollah Ali Khamenei, and only Ayatollah Khamenei. Others disagree. The chances of this option producing positive results, however, are still no better than 50-50.

**Russell:** The Obama administration to its credit is making good faith diplomatic overtures toward Iran. This change in the American tone is a departure from the Bush administration, which stubbornly refused to engage Iran diplomatically outside of the narrow confines of Iraq and Afghanistan. What is missing from the Obama administration's policy is a credible threat of military force against Iran's suspected nuclear weapons infrastructure unless Iran ceases uranium enrichment activities. Without the threat of force to backstop diplomacy, Tehran in the years ahead is going to establish a nuclear weapons stockpile and gravely destabilize Middle East security.

**Sadjadpour:** The nuclear issue is really a symptom of the deep mistrust between the US and Iran, not the underlying cause of tension. For this reason I don't believe there exists a purely technical solution to this issue – it has to be part of a broader political accommodation whereby Washington reaches a modus-vivendi with Tehran and Iran ratchets down its hostility toward Israel. Everyone understands that it will require a long, protracted diplomatic process for America and Iran to reach a political accommodation. The problem is on the nuclear issue; the Obama team doesn't have the political luxury of pursuing a protracted process. The Israelis and congress are already pushing the administration to put a time limit on nuclear negotiations with the Iranians, believing that Tehran wants a long drawn out process simply so it can develop a nuclear weapon behind a screen of negotiations.

Obviously, diplomacy is the only effective option the Obama administration has, but the devil is in the details. I think to come up with an effective policy it is first important to try and discern what the motivation is for Iran's nuclear ambitions. Is it a desire to dominate the Middle East and threaten Israel? National pride? A sense of insecurity vis-à-vis the US? It is surely a combination of several factors, but what we know for sure is that Tehran's leadership, particularly Ayatollah Khamenei, remains deeply mistrustful of US intentions. He is convinced that Washington's goals are not behavior change, but regime change. So if there is a way the Obama administration can take measures to allay Ayatollah Khamenei's sense of mistrust and insecurity, it could have an effect on Tehran's nuclear disposition. A multi-lateral approach is essential.

I would also argue that there is a direct correlation between Iran's nuclear ambitions and America's opposition to Iran's nuclear ambitions. I once mentioned to a former member of Iran's nuclear negotiating team that I don't think this nuclear program was so important to Iran until it became so important to the United States. "That's absolutely right," he said. So ironically, I think that if Washington can turn down the volume a bit, this could also have an impact on Tehran's calculations. I think Obama's team understands this as well. But again, there's going to be a lot of political pressure on them to come down on hard on the Iranians. This is going to be difficult for them to reconcile with détente.

### *How will Iran react to President Obama's proposed "mutual respect" approach?*

**Sick:** I think the Iranians will be watching very closely, since they are extremely suspicious of the US. But the overwhelming majority of the Iranian people want a better relationship with the US, and a gradual normalization of relations is possible over time. Iran and the US have vilified each other for 30 years, and there are domestic political obstacles to a reversal even of the language used on both sides.

**Amuzegar:** The Islamic Republic's reaction to President Obama's proposal for engagement on the basis of "mutual respect" will most probably follow and reflect Ayatollah Khamenei's 20 March 2009 conditionally positive but sceptical address to the nation. In the first official response to President Obama's Nowruz video greetings to Iran, Ayatollah Khamenei, said "the US administration must change its policies toward Iran and the region and end its arrogant approach." Then he added, "if you change your attitude, we will change, too." The operative word in this whole discourse is "change." To President Obama, it means that Iran can "take its rightful place in the community of nations, not through terror or arms, but through peaceful actions." In the context of Washington's long-standing demands, the president's sugar-coated code words mean Iran stopping all further uranium enrichment, withdrawing support from Hamas, Hizbollah, and Islamic Jihad, adopting a neutral, if not conciliatory, position toward the state of Israel, and cooperating with the US in restoring peace and security in Iraq, Afghanistan and the region.

Tehran's expected "practical steps" and "real changes" on the American part, however, consist of an entirely different set of demands to redress a long list of grievances. Outlined in Ayatollah Khamenei's long speech, they include: retracting hostile propaganda about the Islamic regime; halting threats against Iran; stopping interference in Iranian affairs (ie, covert operations); removing US sanctions; releasing Iranian frozen assets; and ending "absolute" support of the "Zionist state." Other Iranian leaders have also criticized Mr Obama. Ex-president Rafsanjani questioned his "sincerity" in his message, finding his policy of "pressure and isolation" no different from Bush's position, and thus representing no "change."

President Ahmadinejad's press advisor has argued that when Mr Obama renews annual sanctions on Iran, calling the Tehran government a threat to US national security, he is following the "crooked ways" of his predecessor. Displeased sentiments such as these are reinforced by statements from two top officials of the Obama administration. In a major policy speech to a NATO conference in Munich in February 2009, Vice President Joe Biden told European leaders that the Obama administration expects them to use military force if Iran will not curb its nuclear ambitions. A similar position was repeated by Secretary of State Hillary Clinton, who said shortly after that if Iran does not comply with the UNSC resolutions "there must be consequences."

**Russell:** I think the Iranians have been caught off balance by President Obama's new tone. The Iranians during the Bush administration had a rather easy time laying the blame for all the region's security problems on the US. The Iranians are now scrambling to craft a response to Obama and so far have sought shelter in demanding unspecified "changes in American policy" before any new relationship with Washington could be considered.

**Sadjadpour:** Iran's reaction so far has been characteristically dissatisfied. During the Bush administration they consistently denounced the US for not showing them proper respect, and now with Obama they say that simply speaking respectfully is insignificant, what is important is to show concretely that US policy has really changed. At the moment, hardliners in Tehran who are not interested in having an amicable relationship with the United States have an inordinate amount of influence. Rather than strengthen these hardliners, Obama's overtures will put pressure on them to justify their often gratuitous enmity toward the US. Most Iranians – certainly the vast majority of the population but I would also argue the bulk of the political elite – recognize that, in 2009, the "death to America" culture of 1979 is obsolete and only prevents the country from fulfilling its enormous potential. Whereas the Bush administration united Iran's disparate political actors against a common external threat, the Obama administration, I believe, is going to accentuate the divisions among Iran's leadership.

*What role can the EU play in resolving the Iranian-western conflict? Can a European policy emerge to bridge the gap?*

**Sick:** The EU has no common policy on this. Originally they took the lead in promoting US-Iran reconciliation. More recently they have adopted the hardline policies of the Bush administration. It may take some time for them to find a new footing as the Obama administration seeks a different kind of relationship.

**Amuzegar:** The EU's role in resolving the Washington/Tehran conflict is significant, but limited, for several reasons. First, the "bad blood" is really between Tehran and Washington. Europe is not directly involved in the dispute and is at best a peripheral and not a principal adversary. Grievances against the US, in addition to the supreme leader's list, start with orchestrating the overthrow of the democratically elected Mossadeq government in 1953; support of Saddam in the 1980-88 war; the 1988 downing of an Iran Air passenger jet; opposition to the Islamic Republic's "theocratic" regime; support of the Tehran government's enemies (ie, the Mojahedin and Baluchi rebels); and the presence of US armed forces in the Persian Gulf region. Second, Europe and the United States do not share common viewpoints on such crucial issues as the Palestinian/Israeli conflict, the future of Iraq and Afghanistan, the status of forces in the Persian Gulf region, and the "right" approach to conflict resolution.

Third, vigorous European diplomacy in the last five years in "critical," and "constructive" dialogues – offering Tehran various carrots, and warning it of possible sticks – have produced no satisfactory results. The entrenched mutual suspicion between Tehran and Washington requires drastic changes in attitude on their own parts. What the EU can do is try to rebuild the burned bridges between the two main antagonists by promoting, facilitating, mediating and maintaining a new, results-oriented dialogue. Fourth, major western European governments do not share a common interest or attitude in their own relations with the Islamic Republic. Germany and Great Britain usually take a much tougher position than, say, Italy or Spain. Thus, the chances of a specific European policy coming to the rescue are not high because Europe's role in the conflict is somewhat asymmetrical. No US policy toward Iran may effectively succeed

without European consent and cooperation. But no specific European approach which encroaches on Washington's basically entrenched position may be of much help.

**Russell:** My sense is that the Europeans are frustrated by Tehran's failure to cooperate on the nuclear issue. EU members, however, will be hard pressed to support tougher economic sanctions against Iran, given the continent's economic downturn and concerns about Russian and Chinese business competition in Iran. On top of that, the EU would balk at any American threat to use military force against Iran's nuclear infrastructure. Such a threat, in my view, is an essential – and up to now missing – ingredient in getting Iran to cease its uranium enrichment activities and to fully cooperate with the International Atomic Energy Agency.

**Sadjadpour:** The EU has a very important role to play, but I don't think a separate and distinct European policy is helpful. In fact I think it could be profoundly unhelpful. Let me explain. What's absolutely critical is that the US and the EU – and preferably Russia and China – address Iran with one voice. Tehran is highly adept at exploiting rifts in the international community, and the entire diplomatic approach will unravel if key countries approach Iran with divergent red lines. I don't mean to imply that Europe should simply defer to the US on Iran policy. On the contrary I think European diplomats generally have a much better understanding of contemporary Iran than American diplomats, given the fact that Europe, unlike Washington, has diplomatic representation in Tehran. I have several European diplomat friends who have spent years living in Iran and speak fluent Persian. The most effective role Europe can play is to work together with the US in shaping a realistic, coherent, multilateral diplomatic approach toward Iran. It is in Europe's interest to make sure there is no air between their position and that of the US. I believe Iran will take them much more seriously if this is the case.

*What impact might the Iranian presidential elections have on talks between Tehran and Washington, or would such a sensitive strategic matter remain the prerogative of the supreme leader, Ayatollah Ali Khamenei?*

**Amuzegar:** Even if the June 2009 presidential election does not produce a *fait accompli*, it will have a largely marginal impact on talks between Washington and Tehran. In Iran's highly complex theocratic oligarchy, all major policy decisions by the president must enjoy the official or tacit approval of the Supreme National Security Council – composed of representatives of the country's clerical, military, security, intelligence and other power centers – all beholden to the supreme leader in one way or another. At the same time, the current supreme leader, despite his vast constitutional powers, is by no means a "dictator" in the 20th century sense, ie a Stalin, Hitler, Franco or Saddam. Seyyed Ali Khamenei is a cautious, prudent, and astute politician, keeping his hold on power by maintaining a delicate balance between opposing vested interests in Iran's fractious society. He frequently takes different positions on various issues when circumstances change. Thus for example, after forbidding any contacts, or even talk of contacts, with the US for years, he made an historic shift in Iran's foreign policy in March 2006 by allowing Iranian representatives to meet with their American counterparts face to face in Baghdad. The election of a president sympathetic to a rapprochement with Washington, particularly a new face enjoying a landslide popular vote, is thus bound to make a difference in the Ayatollah's thinking and position. Beyond this, it should be recognized that Iran's current policy of uranium enrichment for peaceful purposes has, through years of trials and tribulations, become a "cause celebre" and beyond anyone's power to deny. Like the question of the national "right" to oil nationalization during Mossadeq's time, the right to uranium enrichment has similarly become "inalienable."

**Russell:** I do not see any daylight between President Ahmadinejad and Ayatollah Khamenei on dealing with the US. Both men loudly and routinely use anti-American diatribes as staples in their political rhetoric. Mr Ahmadinejad is even likely to ratchet up his public denunciations of the US in an attempt to ride populist sentiment back into presidential office. Anyone on the Iranian political scene who might want a constructive relationship with Washington is likely to be intimidated into silence in Iran's current political atmosphere. Former President Khatami's very short-lived candidacy might have been a victim of this atmosphere.

**Sadjadpour:** A more moderate president in Tehran could certainly help to allay some of the tension that built up during the Bush and Ahmadinejad eras. But in order for there to be a US-Iran diplomatic breakthrough several things have to fall in place. First, there needs to be a president in Washington interested in reaching out to Tehran. We have that in President Obama. Second, I believe we need a president in Tehran who meets two criteria: (1) he is trusted by Ayatollah Khamenei; and (2) the US can work with him. The problem with Mohammad Khatami was that he met the second criteria but not the first. The problem with Mr Ahmadinejad is that he meets the first criteria but not the second. I believe there are a few Iranian politicians who check both these boxes. The current mayor of Tehran, Mohammad Ghalibaf, is one

example. Perhaps the speaker of the parliament, Ali Larijani is another. At the moment, however, neither of them is a presidential candidate.

The foreign policy platform of Mir Hossein Mousavi, the former prime minister who at the moment appears to be Mr Ahmadinejad's most formidable opponent, is still unclear. Ultimately, every Iranian diplomat will tell you that the "relations with the US" portfolio rests firmly in Ayatollah Khamenei's hands. But he leads by consensus, he is not an absolute dictator (though he is closer than he has ever been to being one). I sometimes picture 15 bearded men sitting around a long table, with Ayatollah Khamenei seated at the head. During an Ahmadinejad presidency most if not all of these men share a similar anti-American, revolutionary Islamist disposition. They feed off one another and compete with each other with hostile rhetoric. A more moderate president could change the makeup of who is sitting at that table. Instead of 15 hard-line revolutionary voices, maybe you have five or six people now arguing for a different tack. Their impact might not be enormous, but it would certainly not be negligible either.

*Can Iran pursue its regional policies if the oil price remains at the current level of around \$40/B, or even lower?*

**Sick:** Lower prices make Iran more vulnerable, but the Iranians were pursuing the same regional and military policies back when oil was \$20/B or less. It is important to remember that Iran's actual defence expenditures are only a tiny fraction of the spending by their Arab neighbours in the Gulf and the equivalent to only a few weeks of US operations in Iraq and Afghanistan. The increase in Iran's regional influence is due more to the US invasions of Afghanistan and Iraq than to anything they have done themselves.

**Amuzegar:** Iran's "regional policies," benign or otherwise, do not have much to do with oil prices. The Islamic Republic's economic involvement in the region – trade, aid, investment, and covert activities – is only a fraction of its GDP and total budgetary outlays. Although a very high oil price would make the financing of competing projects much easier, lower oil prices will simply result in eliminating the less important or urgent targets. Crude oil prices of \$40-50/B in the coming months would create tremendous difficulties for the government's finances, with staggering budget deficits already forecast. But since budget funds are fungible, a prioritized foreign project can always be financed at the expense of domestic regular or development outlets. Pakistan and North Korea's pursuit of nuclear arms in the midst of abject national poverty and even occasional food shortages show that politically favored projects can always be financed regardless of the country's financial strength.

**Russell:** Dwindling government oil revenues will hamper Iran's modernization of its decrepit military forces. Russia and China especially seem eager to chip away at the international taboo against selling major armaments to Iran in order to gain export earnings to reinvest in their own military modernization programs. Iran's most effective means of exerting political leverage in the Gulf lie in its ballistic missile and nuclear weapons programs, which continue apace. Iran's support for Iraqi Shi'a militias as well as for Hizbollah and Hamas, moreover, is a low cost but high impact endeavor that is sustainable – and even expandable to elsewhere in the Gulf – in the face of sliding oil prices.

**Sadjadpour:** The contraction of oil prices is certainly painful for Iran, but Tehran was pursuing its current regional policies even in the 1990s, when oil was at \$10/B. So they will undoubtedly have enough in their coffers to continue funding groups like Hizbollah and Hamas. One arena where their ambitions may be tempered is Iraq. I have been told they spent billions of dollars in Iraq over the last several years to try to influence political events there. They may have less money to throw around there now, and given Prime Minister Maliki's apparent accumulation of power, their ability to wield influence is less than before.

*Some sixty prominent Iranian economists have criticized the government for mismanaging the economy. Will the sharp fall in oil revenues prompt the government to heed their advice and take some corrective measures before the presidential elections in June?*

**Sick:** President Ahmadinejad, who promised economic reforms in his first campaign for the presidency four years ago, has failed utterly to fulfill his promises. As a result, he is more vulnerable politically than any other president in Iran's history seeking a second term. That is his greatest weakness, and he may try to remedy the problem (or at least appear to remedy it) before the election. But he has relatively few good options. Instead, he may campaign primarily by castigating his (reformist) opponents.

**Amuzegar:** The economists' letter in question is the third of its type addressed to President Ahmadinejad in the last three and a half years. And the chances of it making any dent in the current government's economic policy before June are next to nil. The reason is that the current president is an opinionated individual who knows very little about economics and is openly proud of it. In addition to a crude, bankrupt and leftist antagonism toward capitalism and the American economic system, he harbours some weird notion of "economic justice," and is possessed by an obsession regarding "nefarious" banks and bank lending. All his knowledgeable colleagues in the Ministry of Finance, the Plan and Budget Organization and the Central Bank who disagreed with him have been fired or have resigned. He considers the authors of the latest open letter as patriotic but misguided intellectuals, brainwashed by western liberalism, and enamored of faux-capitalism. He has on more than one occasion advised them to search for, and come up with, a new, equitable and Islamic economic system. There is no chance of any change before June, because he sees the current global economic crisis and the West's economic convulsions as the precursors of the collapse of capitalism.

**Russell:** The danger is that the continuing deterioration of Iran's economy will lead to increased Iranian belligerency. Mr Ahmadinejad is all too likely to use his conspiracy theories to put the blame for his government's economic incompetence on the US and Israel. He could be even more reckless with the Revolutionary Guards and create a security crisis – such as a hostage taking or military clash in the Gulf – with an eye toward diverting Iranian public attention from domestic economic woes.

**Sadjadpour:** I don't think so. In the nearly four years that he has been in office, Mr Ahmadinejad has not given any indication that he is someone prone to reflection or receptive to outside ideas. These economists have been writing him for the last several years and I do not think he has taken any of their suggestions into consideration. He is convinced of the righteousness of his own views. What's more, his chief mission at the moment is not to fix the economy but to make sure he becomes president again. In some sense these two priorities are incompatible. For example, Iran has one of the highest inflation rates in the world right now, officially 30% but unofficially much higher. Rather than take measures to curtail inflation, Mr Ahmadinejad is going to try and throw money at people in the provinces to make sure they turn out and vote for him (he knows the urban sophisticates in Tehran and elsewhere are not his constituents). Obviously this is only going to increase inflation. But again, his priority is not the long or even medium-term health of the Iranian economy; his priority is essentially to bribe people to support him. What's unclear is how much access he has to the country's purse strings to carry out such a policy. Theoretically the parliament is in control of the budget, and Mr Larijani, being no fan of Mr Ahmadinejad, will try to deny him access to the funds. But the reality is that finances are incredibly nebulous in Iran, and if the leader decides he wants Mr Ahmadinejad to serve a second term, he can certainly make the funds available to him.

### *What are Mr Ahmadinejad's chances of re-election and what would be the impact of such a development on a potential US-Iranian rapprochement?*

**Amuzegar:** Mr. Ahmadinejad's reelection chances are based on a number of vastly different factors. Despite his gross mismanagement of the economy and other mistakes he still enjoys some support among the poor and the rural voters. But other factors are not in his favor. To begin with, since he is disliked by intellectuals, students, women, workers and other urban voters, and is equally out of favour even within his own political camp, it is possible that some other "principlist" candidate in that camp might enter the race and challenge him on his own turf, splitting the conservative vote. So far, no one in this camp has announced a candidacy. But potential candidates like mayor of Tehran Mohammad Ghalibaf, Majlis speaker Ali Larijani, and Expediency Council secretary Mohsen Rezai are frequently mentioned. Given his unenviable record and his latest legislative defeats in the conservative Majlis, a more attractive conservative candidate like Mr Ghalibaf would indeed be likely to beat him in the first round.

A second factor relates to the candidates from the rival "reformist" camp – how popular they are, how effectively they campaign, and how widely they split their own constituents' votes. So far, there are only two candidates running, Mr Mehdi Karrubi and Mr Mussavi. They both have vowed to stay in the race until the end. But if one of them withdraws in favor of the other, and no other "reform" candidate is in the race, Mr Ahmadinejad's chances will be measurable diminished. Thirdly, there is increasing talk of the need for a "coalition government" under a candidate acceptable to both camps, in which case Mr Ahmadinejad will have no chance of being selected. Fourthly, there is the question of the elections being "free and fair."

In Mr Ahmadinejad's 2005 election, two major rivals – Mr Rafsanjani and Mr Karrubi – openly questioned the outcome, and complained about having no recourse to a higher authority. With the incumbent's controversial lieutenants now in charge of the elections, and with no international observers allowed to oversee the results, the outcome may not reflect the voters' final verdict. Finally, and most crucially, the fate of the elections will depend on the decision of some 20mn

(out of 46mn) eligible voters who did not participate in the second round of the last presidential elections. Experts calculate that less than 20% of voters in each of the two camps are diehard loyalists and that some 60% or more of the electorate can shift one way or another. Thus if the 20mn fence-sitters of the 2005 elections decide to stay home once again, the incumbent's chances will be significantly increased.

As to the probability of a US/Iranian rapprochement being affected by the election's outcome, it ought to be noted that a possible detente is threatened far more by an erroneous notion shared by all Iranian presidential candidates than by the result of the election. This is that at the current juncture there is no need for Tehran to compromise: Washington is in weak position because the American economy has run aground; the Americans are worried about further instability in the region; and they need Iran more than Iran needs them.

**Russell:** I think the smart money would be riding on Mr Ahmadinejad's re-election. He has placed a good many Revolutionary Guard members in his government and enjoys the backing of that increasingly influential institution. Mr Ahmadinejad and his cronies also are adept at scaring away would-be "reformers" in Iranian politics. His re-election would seriously damage the prospects for an American-Iranian political rapprochement, given what I see as a fundamental hatred, suspicion and resentment of the US at the center of his worldview.

**Sadjadpour:** I think we should use the term "election" loosely. Iran's presidential elections are not as rigged like, say, Egypt's, but they are certainly not free and fair. I would argue that in this particular election the will of Ayatollah Khamenei will figure more prominently than the will of the people. Indirectly, via the Guardians Council, he will limit the pool of candidates permitted to run. And in a country that lacks organized political parties with grassroots activity, the campaign role played by paramilitary and military organizations loyal to Ayatollah Khamenei could prove decisive. This is what helped propel Mr Ahmadinejad's 2005 victory. There are also many allegations of improprieties that take place when it comes to ballot counting. One reformist politician, Ali Reza Alavi Tabar, said that if the reformists wanted to win this time they would need 5mn more votes than the conservatives to compensate for any improprieties.

Finally, it is difficult to gauge popular sentiment outside the capital. Though Tehran is the country's political heart and soul, the low voter turnout among disaffected urban sophisticates in Tehran means they are no longer making electoral decisions for the rest of the country. Mr Ahmadinejad has understood this, making frequent visits to the provinces with promises of economic handouts. Having said all of this, Iranian elections are notoriously unpredictable. Mr Ahmadinejad looks like the front-runner at the moment, but I think his defeat is certainly within the realm of possibilities. If indeed he is chosen to serve a second term, I fear that his continued presence would be an insurmountable obstacle to US-Iran confidence building. As long as Mr Ahmadinejad is president, I would put the chances of a US-Iran rapprochement at close to nil.

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# Analyses

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## *Some Comments About Oil Prices And Financial Markets\**

By Sadek Boussena

### **What Happened To Oil Prices In 2008?**

No one contests the fact that in 2008 oil prices reached record heights due to a financial bubble created by speculation based on the easy availability of credit and leverage.

This was the result of huge investments in oil financial instruments (such as futures, OTC and indices products) by a new kind of player. Initially, speculation was based on real fundamentals – a rapid increase in emerging countries' consumption and a reduction of spare production capacity in OPEC countries. But subsequently speculation became based on less realistic factors such as alarmism about peaking oil production, doubts about national oil companies' ability to develop production capacity and geopolitical risks.

It seems that some analysts convinced numerous investors of the inevitability of higher prices in future and predicted that prices would reach \$100/B, \$150/B, \$200/B and even more before 2010. In the context of this bullish trend, players such as hedge funds, pension funds, and exchange trade funds considered oil to be a better asset than other alternatives. Electronic oil futures exchanges provided more opportunities for these investments. With such huge amounts of cash in play, transactions on oil financial markets moved to a very high multiple of global physical demand. This added a speculative layer of demand to the physical one and forced prices higher.

Although many analysts were saying that the fundamentals did not justify such a price increase – demand was already decreasing – they were not listened to. Future oil prices reached record heights in July 2009, with WTI at \$147/B. At that moment, prices reflected the supply and demand of futures contracts more than physical oil balances. Prices would therefore have collapsed at some point, recession or no recession. It was only a matter of time.

Already impacted by price elasticity and the downturn in the economy, the slowdown in oil demand was exacerbated by falling demand in futures markets due to the credit squeeze, greater aversion to risk and a huge deleveraging process. The speculative bubble burst. Without OPEC cuts, oil prices would probably have fallen to a lower level than the \$33/B they did reach. The logic of financial markets could have exposed oil, as a financial asset, to the same fate as shares on stocks markets.

### **What Lessons Can We Draw From This Oil Price Experience?**

1. The main one is the important role financial markets now play in determining oil prices. Recently, some analysts have tried to find a correlation between oil prices and stock market movements, as they did last year with value of the US dollar. These factors do indeed impact prices, but on structural basis oil prices are the result of a more complex supply/demand equation. In the new market, supply and demand are still the consequences of production, consumption and stocks in the real economy, but we cannot ignore the layers of demand and supply created by futures contracts, at least for hedging purposes. In their market assessment, analysts have already started to take this into account.
2. As far as concerns oil pricing, the role of speculation has increased. Usually, speculators do not create movement, but they may exaggerate it. However, in this instance the new financial players in oil markets, lacking other opportunities, decided too quickly to follow a course based on a false diagnosis. Investors were misled. Their advisers did not take into account the risk of a bubble, of an economic recession and a drop in demand; they rejected the idea of a price correction. The price collapse should also be a lesson for the new players with their mistaken perception of how the oil market works. They may well be more prudent in future as far as the oil market is concerned, having rediscovered that in the final analysis fundamentals are the true drivers of prices.
3. Oil markets are integrated into the global economy. In financial markets oil fundamentals are not the only criteria; financial investors are also influenced by the asset value of oil relative to other financial investments.
4. More players, especially non-commercial ones, more transactions and quicker reactions thanks to electronic tools have all led to greater volatility than in the past. Prices will probably fluctuate over a very large band with two limits: the lower allows producers to cover the operating costs of existing non-OPEC output and the upper reflects the marginal cost of development of credible new alternatives to conventional oil. This means a range between \$20-30/B (the present cost of

deep offshore and tar sands oil) and \$80-90/B, which represents the cost of developing green-grass projects such as tar sands in Canada or sub-salt Brazilian offshore oil. Prices could exceed these limits, but only for short periods.

5. Financial market oil prices are perhaps sending good signals for short-term investment purposes, but not for those of the oil industry. These signals are not instructive and do not reflect marginal costs either in the short or long term. High volatility brings greater uncertainty, and this has a negative impact on industry investments.

6. Producers and consumers have a common interest in fostering greater market stability through stronger regulation of energy financial markets, especially as far as derivatives are concerned.

### **Can Producers Influence The New Oil Market?**

It is pointless for producers to try to influence futures markets directly. Firstly, to take on the world financial system would be an unequal match. Secondly, they have a better tool.

With only \$500bn in export revenues and much less in cash, OPEC cannot match the huge amounts of capital moving in financial markets. The national oil companies, sovereign funds and central banks of the exporting countries could intervene, but their weight is too small to confront the global flow of capital. When speculation is rampant – as was more or less the case during the fourth quarter 2008, when OPEC was chasing the fall in demand not only in the physical market but in the financial market as well – it is difficult for producers to contain it. However, financial movements cannot remain divorced too greatly from reality for too long. When the logic of fundamentals returns, physical markets assume a greater weight in the behaviour of financial players and the producers' position is stronger.

Some signals suggest that we are now moving back towards a more fundamental pricing mechanism. However, with no prospect of any revival in demand, with credit constrained and risk aversion still prevalent in the market, speculative volumes are unlikely to reach last year's level in the near future. The only way for prices to rebound is for the producers to cut their output.

OPEC's effectiveness in reversing downward price trends will depend on its ability to force an inventory drawdown in the OECD countries. OPEC output cuts have already halted the collapse in prices. They have also started to narrow the current contango in the markets, with potential consequences for inventories.

### **Producers Can Use Futures Exchanges As Leverage**

By introducing adequate and timely cuts, oil producers could use futures markets to influence the physical market. If supply matches demand, it is possible to prevent inventories from building. This will turn short sellers into buyers in the future markets and backwardation will be restored.

We are at a crossroads. The key question for producers is when the global economy will hit bottom and what the level of future demand is likely to be. In the short term prices will stay weak until physical and/or speculative demand recovers or supply is brought in line with the new level of demand. Should the OPEC cuts make the short-term economic outlook clearer, if confidence in the world financial system returns, and if medium-term oil fundamentals are favorable due to lower upstream investments, speculators who are still seeking a profitable class asset will return to long positions in oil futures markets. In that case, speculation in financial markets could help oil prices to rebound before the world economy bottoms out.

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\* Mr Boussena is a former Algerian Minister of Energy. He presented this paper to the OPEC International Seminar, Vienna, 18-19 March 2009.

## *Volatility Prolonged: The Russian-Ukrainian Gas Agreement Remains Hostage to Kiev's Political Squabbling*

By Theodoros Tsakiris

On 19 January following a weekend of negotiations between the prime ministers of Russia and Ukraine, Vladimir Putin and Yulia Timoshenko, the two countries signed an agreement that calls for Ukraine to pay European-level prices for gas in 2009 with a 20% reduction in exchange for leaving transit fees unchanged at the 2008 level, namely \$1.60-1.70/1,000 cu ms of transited gas per 100km of transit. That should amount to approximately \$360/1,000 cu ms for Ukrainian imports during the first quarter of the year, which would be substantially reduced thereafter in order to reflect the steep drop in oil and fuel oil prices since July 2008. The average Ukrainian price for 2009 is expected to be marginally lower than \$250/1,000 cu ms, compared to a European price of \$280/1,000 cu ms. On 31 December Kiev declined that same price offer from Gazprom, leading to the collapse of Russian-Ukrainian negotiations and the worst crisis in the 40-year history of east-west energy trade.

In 2010 both the cost of Ukrainian imports and the cost of Russian transit fees will be adjusted to international prices. The agreement does not address the issue of how Ukraine will pay for the "technical gas" that is needed to operate the network, and it is still not clear how much Gazprom's major EU partners, Gaz de France, E.ON and ENI, will contribute in order to share the burden of a probable credit line to Naftogaz of up to \$1bn, which is how much the "technical gas" is expected to cost. The agreement, which has a life span of 10 years, calls for the elimination of the Swiss-based trader RosUkrEnergo (RUE), which is 50% owned by Gazprom, in a renewed effort to bring more transparency to the bilateral gas trade.

The ink was scarcely dry on the gas agreement before political problems in Kiev started to weaken the deal. With presidential elections looming and with President Yushchenko and Prime Minister Timoshenko at loggerheads, the country remains effectively without a government. The president's approval rating bottomed out at a low of 2.4% at the peak of the crisis on 12 January, and Ukraine's "pro-Russian" Party of the Regions, which holds most of the seats in the country's parliament, filed a motion for Mr Yushchenko's impeachment on 13 January.

The party is led by Viktor Yanukovich, the oligarch from Ukraine's eastern industrial heartland whom Mr Yushchenko defeated in the third round of the 2004 Presidential elections. With this variety of political players it should not have come as a surprise that Kiev was unable to speak with one voice during the January negotiations that resulted in the agreement to resume European gas exports and keep Russia's Ukrainian transit fees frozen for all of 2009. Another bone of contention is the different estimates of the actual cost of Russian exports to Ukraine. The president's office and Naftogaz Ukraine have calculated that Russian gas imports will cost Kiev \$360/1,000 cu ms in 1Q 2009, \$270/1,000 cu ms in 2Q, \$219/1,000 cu ms in 3Q and \$162/1,000 cu ms in 4Q, resulting in an average price of \$252/1,000 cu ms, \$2 higher than the price the Ukrainians rejected on 31 December. Mrs Timoshenko insists that Kiev will not pay more than \$228/1,000 cu ms on average. Even if she is proven to be correct, which Ukraine's own national gas company seems to doubt, the price would still be too high for a country that had to borrow up to \$16.5bn from the IMF in order to avert the danger of bankruptcy in October 2008.

On 23 January Mr Yushchenko's senior energy security advisor, Bohdan Sokolovskiy, joined in the barrage of criticism by saying that Mrs Timoshenko's agreement "constitutes a major imbalance in Naftogaz's financial flows that bears the risk for our country's national security." On 26 January Mr Sokolovsky warned in a statement issued by Mr Yushchenko's office that "the agreement between Naftogaz and Gazprom could be declared invalid if it was concluded under pressure. There are reasons to doubt that Oleg Dubina [Naftogaz's CEO] was able to sign the documents knowingly and of his own free will."

Mr Dubina suffered a heart attack following the end of the January crisis and was hospitalized for some days. On 24 January Mrs Timoshenko said that the contradictory orders Mr Dubina received from her and President Yushchenko during negotiations in Moscow on 19-20 January had been so stressful that they almost caused a heart attack. Mr Yushchenko has now said that the Putin-Timoshenko deal may be revised as early as 2010, and as the president indicated the possibility of replacing the 20 January agreement, Naftogaz approached collapse. The company announced on 24 February that it is being brought to the brink of bankruptcy by major difficulties in collecting up to \$563mn of gas bills owed by municipal consumers. A Naftogaz statement warned "of a potential worsening of the situation with payments to Gazprom due to the catastrophic rise in debts of regional municipal utility companies." This situation, combined with a delay in the release of the second tranche of the IMF loan, raised the prospect of another gas supply crisis if Russia

decides to reduce or cut supplies to Ukraine if it fails to pay its monthly bills according to the terms of the 20 January agreement.

Ukraine needs the release of the IMF loan if it is to meet its next payment, due on 7 March, but the IMF is understood to be blocking the release because of concerns over continuing Ukrainian gas subsidies and the solvency of the country's central bank. As Naftogaz was about to pay its bill in full on 7 March, it came under attack from Ukraine's security service, the SBU. On 4 March the SBU raided the central offices of the state company as part of a government investigation into allegations of the illegal diversion of almost 6.3 BCM of imported Russian gas in recent months. In an interview with Russia's RIA Novosti news agency, a Naftogaz spokesman said that SBU agents demanded to see the original Supply and Transit Protocol documents signed by Mr Putin and Mrs Timoshenko on 19 January.

On 11 March Ihor Umanskiy, Ukraine's acting finance minister and an ally of Mrs Timoshenko, submitted a request to his Russian counterpart, deputy Prime Minister Alexei Kudrin, for a "\$5bn loan that will be used to buy gas." Mr Kudrin was quoted on 10 March by RIA Novosti as saying that "Yulia Tymoshenko had officially asked Russia for a \$5bn loan. We are holding consultations with Ukrainian Finance Ministry officials, [but] no decision has been made yet." Mrs Timoshenko has been unsuccessfully trying to secure additional credit lines to meet high Russian gas prices over the first two quarters of 2009. She has so far failed to persuade any EU financial institutions and has been unable to secure the release of the second tranche of around \$2bn from the \$16.43bn Ukraine secured from the IMF in October 2008. The first instalment of approximately \$4.5bn was released by the IMF in November 2008. It is unclear what kind of collateral the Russians might seek and what kind of collateral Kiev would be able to offer if Moscow agrees to the loan.

Moscow is not likely to come to the assistance of Mrs Timoshenko any time soon. The Russians appear to have been displeased by the rapprochement between Mrs Timoshenko and Mr Yushchenko over the appointment of Valentyn Nalyvaichenko, a seasoned diplomat, as head of SBU. Mr Nalyvaichenko has been serving as acting director of the SBU since 2006 because Ukraine's parliament, the Rada, has refused to ratify his appointment by President Yushchenko. Another reason for Russia's decision not to bail out Mrs Timoshenko relates to the fate of approximately 11 BCM of gas stored in RosUkrEnergo (RUE) facilities that Naftogaz is claiming as its own. RUE, the 50% Gazprom owned intermediary company that is abolished from the Russian-Ukrainian deal, with the support of President Yushchenko, sued Ukraine's own custom authorities and Naftogaz for the "illegal transferring of 6.3 BCM" of gas located in its storage facilities. On 12 March Ukraine's customs officials resumed transferring the ownership rights to the 11 BCM of RUE gas to Naftogaz, which claimed the gas following the January supply and transit agreement with Gazprom.

As Russia declined to rescue Ukraine from the brink of bankruptcy, Mrs Timoshenko turned to the country's European allies, the Baltic states and Poland, who came up with a proposal to consolidate EU-Ukrainian relations which deliberately failed to make any reference to the third party whose gas the EU imports – Russia. Moscow did not take it lightly. A few hours after Ukraine signed a declaration of cooperation with the European Commission that calls on the EIB, the World Bank/IFC and the EBRD to finance up to €2.5bn (\$3.3bn) worth of projects over the next three years to help rehabilitate Ukraine's gas transmission system, Russian Prime Minister Vladimir Putin strongly criticized the deal. "If Russia's interests are ignored, we will also have to start reviewing the fundamentals of our relations. We would very much like for things not to reach this point," Mr Putin said. The declaration called for the construction of new gas turbines and new metering stations that would help to restore the pressure in some parts of the system and increase its transparency. In exchange Ukraine is accelerating its accession talks with the Energy Community (EC), an international organization that promotes the EU's energy laws to non-EU states.

In a statement to RIA Novosti, Sergei Shmatko, Russia's Energy Minister who was present at the EC-Ukraine conference and who walked out of the room at the signing of the document, told the Russian news agency that "while recognizing the urgency of the task to modernize [the Ukrainian gas transportation system] and expressing a readiness for any format – bilateral or trilateral – to participate in this work, we were forced to express our bewilderment with the fact that Russia was practically excluded from the discussion of this issue, which is very important for all of us." Even though the agreement does not commit any EU member-state, Moscow strongly believes that it should have participated in the process of its drafting and its signature.

The \$3.4bn pledged is hardly enough to reconstruct Ukraine's dilapidated, 37,000km Soviet-era transit system. Gazprom calculates that a serious modernization effort could cost up to \$16bn, which Ukraine does not have and is not likely to raise in the foreseeable future. The system is so decrepit that only 70-75% of its technical capacity is usable. The poor condition of Ukraine's transport infrastructure was illustrated in 2007 when a powerful blast destroyed a 50-yard stretch of the Brotherhood pipeline, a major carrier of Russian natural gas to Europe. Russia has always tried to make the

modernization of the Ukrainian transit system conditional on its privatization, a process that came close to being completed with German and Italian support in 2002-03.

On 24 March Russian President Dmitry Medvedev told an extraordinary meeting of the country's National Security Council that he has decided to postpone Russian-Ukrainian talks scheduled to take place in early April on the price of Russian exports for the second quarter of 2009 until "after Russia has received answers to its questions. This [EC-Ukraine] declaration raises questions." On 25 March Paolo Scaroni, ENI's CEO, was quoted by the *Moscow Times* as saying that "any plan without involving the supplier is a waste of time and a waste of money." Mr Scaroni was meeting Russia's Deputy Prime Minister Igor Sechin in Moscow for talks on the development of ENI's strategic partnership with Gazprom.

ENI's CEO repeated his company's support for the 2002-03 Russian-European proposal to privatize Ukraine's system by noting that "we believe – and I think that other major companies such as [Germany's] E.ON and Gaz de France also think – that it is necessary to return to the old idea of setting up a consortium which would secure stable gas supplies." In an attempt to play down the situation, Mrs Timoshenko told a news conference in Kiev that same day that "neither Russia nor Europe lost yesterday. Ukraine simply defended its national interests. Russia can also take part in investment projects, in reconstruction and modernization."

Even though Moscow toned down its criticism over the first week of April it still refuses to start any pricing negotiations with Kiev, and the situation could deteriorate as Ukraine enters a protracted pre-electoral period. Ukraine's parliament, voted on 31 March to set 25 October as the date for early presidential elections, three months before to the date when the mandate of President Yushchenko was due to expire. Despite Mrs Timoshenko's victory over the president, there was an apparent rapprochement between the two erstwhile opponents at Mrs Timoshenko's initiation. Mrs Timoshenko said that she wanted "to cooperate with the president, seek constructive cooperation with lawmakers who support him, and serve Ukraine. I am asking for an end to political passions. The presidential campaign starts four months before the election, so I am asking you to wait until September before seeking political dividends." As a result of the political turmoil in Ukraine, parliament has failed to pass three of the five anti-crisis bills proposed by the government, which were blocked by the pro-presidential Our Ukraine faction. Mr Yushchenko was apparently retaliating for the fact that the Timoshenko-Yanukovich controlled parliament blocked a presidential bill to amend the 2009 budget spending and introduce news laws that would facilitate the release of IMF funds. Ukraine is in desperate need of these funds if it is to cope with the rising gas bills Gazprom is charging.