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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

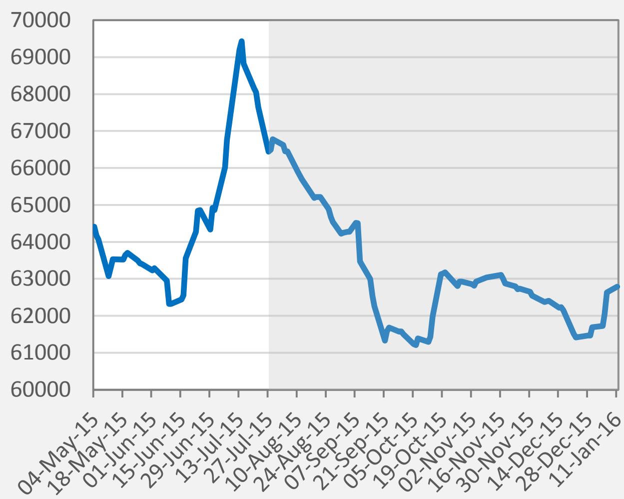
54 First Published: 12th January 2016

Reform is the word, for a post-sanctions economy

With the moment of sanctions relief upon us following "implementation day", the Iranian government is setting out its reform agenda to successfully transition to the post-sanctions economy. The 1395 budget plan chimes with IMF prescriptions for fiscal consolidation, banking reform and privatisation. Regional tensions and posturing complicate the transition and provoke JCPOA sceptics in the West.

Iran remains within touching distance of the historic removal of international economic sanctions, and a unique economic opportunity. Since the International Atomic Energy Agency ruled on 15 December 2015 to close the file on the Previous Military Dimensions (PMD) of Iran's nuclear programme, the Iranian authorities have kept their side of the agreement by disabling the core of the Arak reactor and transferring enriched uranium stocks out of the country. The conditions were met for "Implementation Day" to be announced as anticipated and we now look to the removal of international economic sanctions that will follow.

Fig 1. Iranian stock exchange (Tedpix All-share)
04-May-15 to present

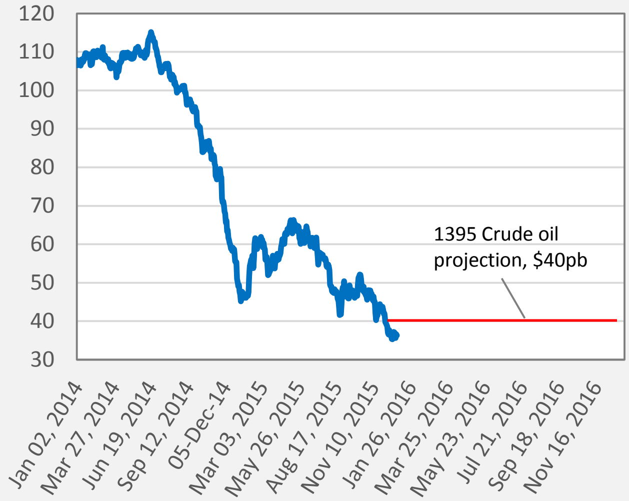


The escalation in regional tensions with Saudi Arabia complicates the transition to a post-sanctions era, however. Rising animosity affects the risk calculations of regional investors and is likely to impact tourism as well as oil revenues for the foreseeable future. Iranian revelations of a new underground missile depot also served to provoke the lingering fears of hard-liners in the US Congress and led to speculation of a fresh round of financial sanctions being called upon Iran. The prioritisation of defence and security issues also has financial implications. House Speaker Ali Larijani announced on a visit to the base that the Majlis' financial support for the missile sector was "guaranteed" in the 6th Five-Year Economic Development Plan. Verity-Iran understands there are concerns within the Finance Ministry about the budgetary pressures of defence commitments given the squeeze on government revenues and the myriad other spending priorities.

In this context, some sceptics have argued the US administration is "stalling" on the finalisation of the deal; the truth is less exciting. The web of financial sanctions that have been wrapped around the Iranian economy over the past decade are highly complex and take time to undo. Similarly, the technical requirements of the JCPOA on Iranian nuclear engineers take time to carry out safely and effectively. The Deputy Iranian Foreign Minister Araghchi himself said on the 15th December that implementation day would take around a month, give or take a few days to allow for potential delays. For all the scepticism and speculation, the landmark announcement was announced as scheduled.

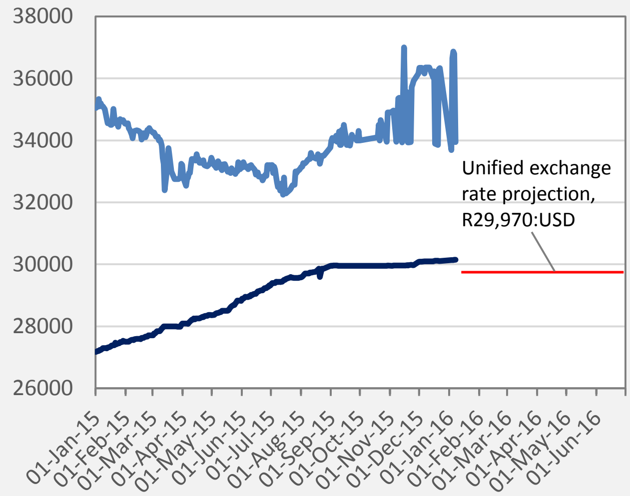
Nevertheless, the US Congress has continued to place pressure on the JCPOA. A congressional bill proposing a change to the administration of the US Visa Waiver Program is designed to require greater scrutiny of any entrants to the United States who have recently visited Iran. It is thought the move could potentially undermine Iran's ability to attract businesspeople, tourists and foreign investors to the country. Meanwhile, draft legislation has been put to Congress aimed at disrupting the planned sanctions relief. The administration has robustly rejected the draft bill and remains publicly committed to the JCPOA.

Fig 2. Brent crude oil price (USD pb)
January 2014 to present



President Rouhani's government has proposed a number of significant reforms in the 1395 budget proposal (the year from 20 March 2016), which it handed to the Majlis for review in December. The budget was delivered alongside the Islamic Republic's 6th 5-year economic development plan (2016-2021). Projections are based on the assumption of an oil price of $40 per barrel, anticipating a rise from the current price of around US$36 per barrel (See Fig 2). The budget also presumes a dollar exchange rate of 29,970 rials and the Central Bank Governor recently restated his claim that the unification of the official and market rial:dollar exchange rate was about to happen within the next 6 months (Fig 3). The two documents provide something of a blue print for the reforms required to transform Iran into a vibrant post-sanctions economy. The budget predicts a GDP growth rate of 5-6% in 1395, and inflation at 11%.

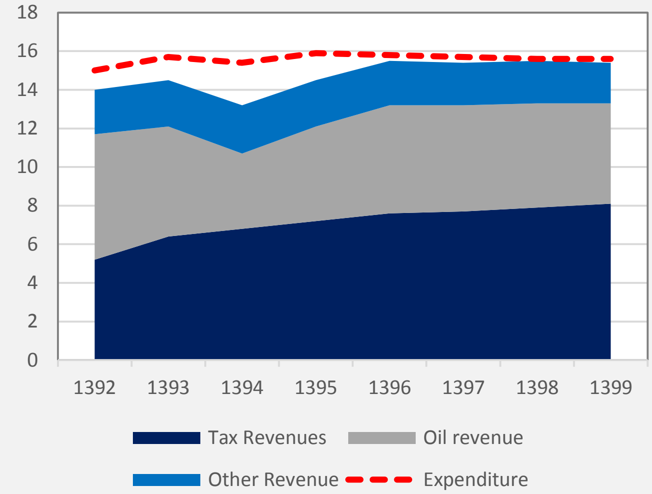
Fig 3. Iranian Rial to USD exchange rate
Official (dark blue), market (light blue)



The government's forecast of 5-6% GDP growth for next year overshoots the official forecasts of the International Monetary Fund, which recently projected 4-5.5% growth. The IMF published its annual Article IV report on the Iranian economy in December, which anticipated a boost to GDP growth from sanctions relief through lower costs for trade and financial transactions, higher oil production and restored access to foreign assets. The level of improvement in GDP growth will depend on spill-overs from the booming oil sector. The IMF stressed the need for gradual fiscal consolidation through better tax revenue mobilisation and subsidy reform as well as prudent monetary policy. It also stated the need for comprehensive reforms to the business environment to ensure the expected lifting of sanctions has a significant impact on confidence and investment and places the economy on a higher and more inclusive growth trajectory over the medium term.

The transition to a post-sanctions economy is already underway and will prove to be a crucial, defining period for the Rouhani administration. The government has recently been discussing promising initiatives to modernise the tax base, stabilise the financial sector, constrain corruption and reduce inefficiencies. Economy Minister Ali Tayebnia claimed that historically, rising oil revenues had masked the urgency of developing a modern taxation system in Iran. He claimed the lack of a comprehensive economic database, widespread tax exemptions, complicated and ambiguous regulations and a failure to uphold the law are placing a cap on potential tax revenues, which amount to less than 7% of GDP (See Fig 4.), which is around the third of the level found in some Western European economies. With oil income depressed, the need to formalise and expand the tax base is greater than ever. Over 43% of the Iranian economy is tax exempt, including many state-controlled companies. These privileged but inefficient entities have thrived thanks to exemptions and are damaging to the long-term competitiveness and wellbeing of the economy. The Minister has claimed next year's reforms to the tax code, including more targeted incentives, an expansion of the tax base and a removal of discriminations will reform the system.

Fig 4. Iranian government balance shseet
Area graph revenes, dotted line expenditure (IMF)



The banking sector will seek to consolidate its balance sheets following sanctions relief, but will also face new risks and uncertainties from its exposure to external competition and international capital flows. On the plus side, Iranian banks will regain access to international financial messaging services (SWIFT) to enable cross-border transactions. They will be granted greater freedom to manage their own international reserves and holdings, and those that are white-listed will be able to resume activities internationally. But the sector will require major reform, sound management and a strong dose of luck if it is to avoid a crisis in 1395. Some analysts claim as much as 50% of loans are not-performing, locked in a real estate market not showing any signs of recovery, or over-extended manufacturers with excess inventories, not to mention the huge government debts that have been racked up in the private banking sector. A large amount of banking capital is out supporting state owned entities, such as the big cement, steel, and ceramics producers that are lumbered with excess inventories and poor growth prospects. Resolving those toxic debts will require time, confidence in the banking sector and a steady period of economic growth.