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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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Sanctions lift a catalyst for sensible economic reforms

Implementation Day finally arrived for the Iranian economy, sparking the financial markets into life and unlocking a large back-log of international transactions. The JCPOA itself does not fix Iran's deep seated economic constraints, but with luck it will catalyse the sensible economic reforms designed to convert Iran into a modernised, diversified and high-growth economy. Despite the positive outlook, investors remain wary of the real risks of the deal coming undone.

After many months of waiting, the arrival of "Implementation Day" means Iranian enterprises and international investors can finally begin to put plans into action. The lifting of a large section of international financial sanctions has sparked what many hope to be an economic revival. The Tehran Stock Index grew by more than 20% in the past month (Fig 1), reaching a multi-year high (Fig 2). The Iranian rial has strengthened more than 3 percentage points on the open market in the same period, albeit off the back of a 6-month weakening trend (Fig 3). In the wake of the announcement, President Rouhani chose to highlight the benefits of the deal to the Iranian entrepreneurs who can start to trade and export once again through legal and normal channels, the Iranian banks that can access the monetary and banking services they need from around the world, and the Iranian companies that can purchase modern airplanes to improve aerial safety.

Fig 1. Iranian stock exchange (Tedpix All-share)
1 Dec 2015 to present

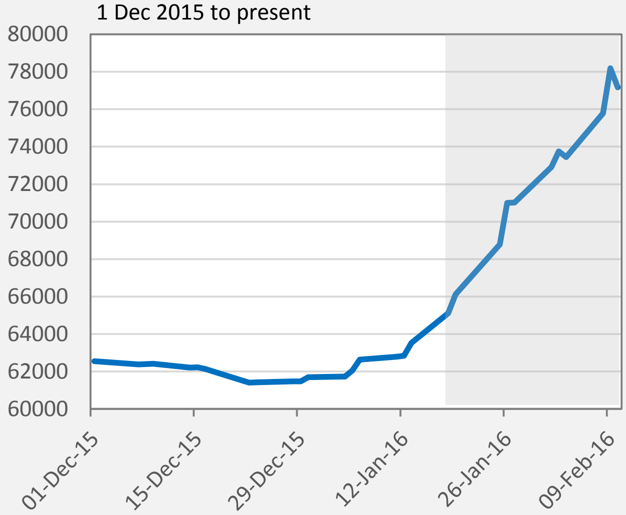
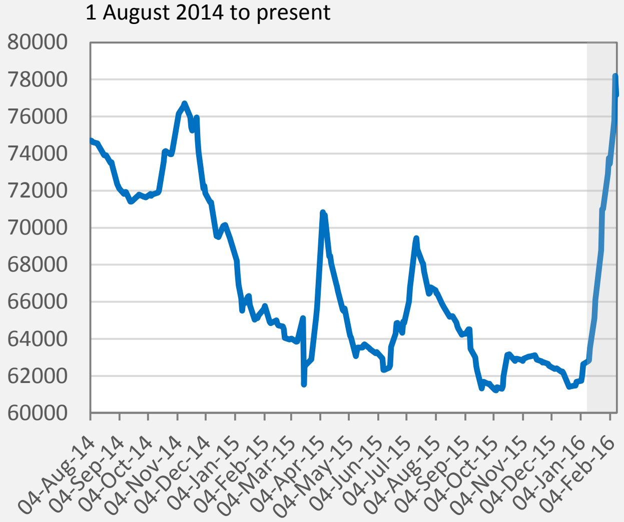


Fig 2. Iranian stock exchange (Tedpix All-share)
1 August 2014 to present



Real impacts will be felt quickly in the financial sector and consumer goods. The Central Bank of Iran claimed that import costs for Iranian firms would decline by more than 10% as the normalisation of banking relations allows the banking sector to issue letters of credit and guarantees through legal channels, which in turn will reduce money transfer and payment expenses. Applications were filed for more than 1000 letters of credit within one week of implementation day, according to the Industry and Commerce minister, Nematzadeh.

The largest volume was for raw materials for the production and industrial sector, as well as the import of machinery.

At a more cautious pace, the door is also now open for large flows of foreign direct investment into Iranian industries. Rouhani called for private and government sectors to absorb US$50 billion of foreign investments as part of the government's ambition to realise an 8 percent economic growth rate. Iran's mining sector has now more than US$10 billion investment pledges by the Europeans and Chinese firms.

Iran loaded its first cargo of oil to Europe since implementation day on February 14th. The National Iranian Oil Company is planning three initial shipments to Europe carrying 4 million barrels of oil, with 2 million barrels heading for France's Total and the rest to companies in Spain and Russia. Many analysts predict an escalation of Iranian exports will worsen a global supply glut that has helped push oil prices to 12-year lows. Prices fell to US$28 per barrel at one point last month. (Fig 5)

Fig 3. Iranian Rial to USD exchange rate

Official (blue), market (red)

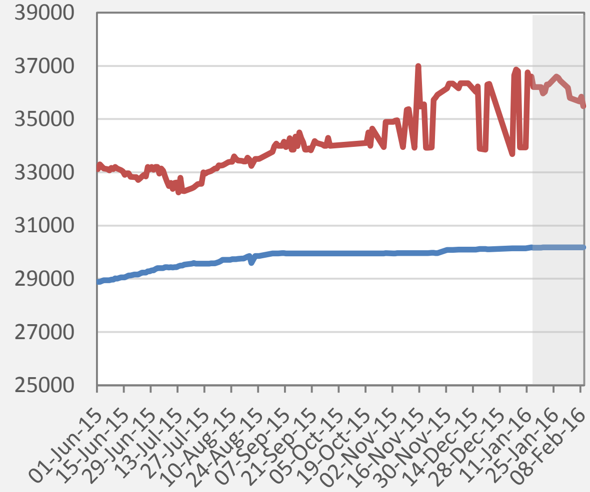
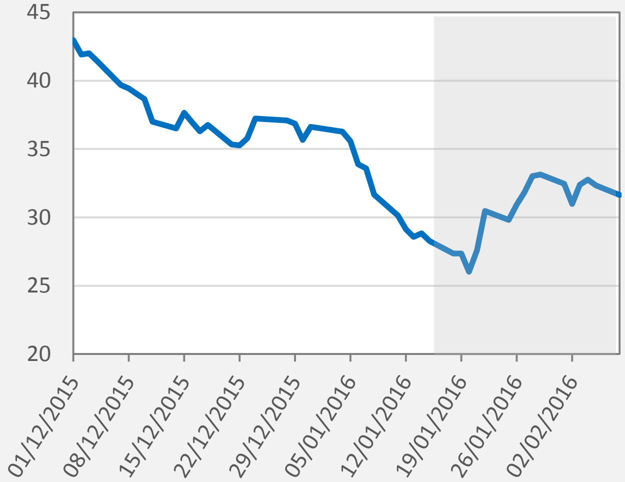


Fig 4. Brent crude oil price (USD pb)

1 December 2015 to present

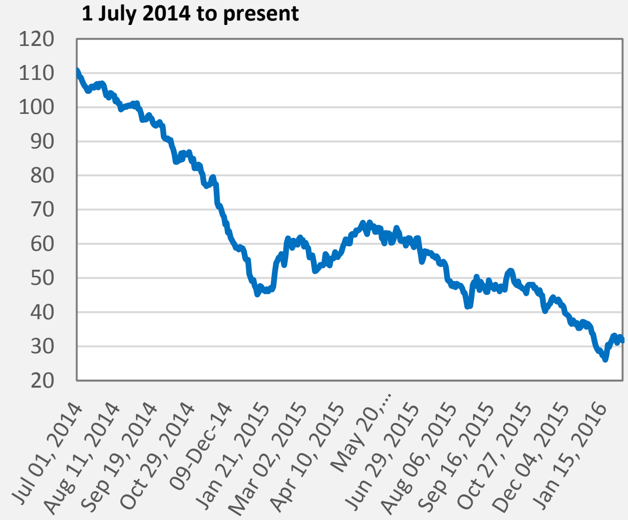


The Iranian government announced that a deal had been agreed with Airbus to modernise the Iranian airline industry with the purchase of 138 mid to long-range aircraft over the coming decade. The deal is worth US$10.5billion mostly under hire purchase or lease agreement with Airbus providing the initial credit, which will be supplemented by further credit from international sources and repaid through future revenue streams.

For the Iranian economy, this is the start of a long process of reform, not the end, and economists warn against getting too optimistic about the short term returns. There are deep-seated problems in the Iranian economy that the JCPOA does not address. Harmful economic laws and regulations dampen entrepreneurship and productivity; patronage and corruption waste resources and distort incentives. What the JCPOA does present is an opportunity to catalyse the impact of economic reforms and to achieve a sustainable period of growth. Implementation day could be the turning point in the long road to a more diversified, free and competitive economy. That prospect is very exciting, for Iran investors indeed.

Fig 5. Brent crude oil price (USD pb)

1 July 2014 to present



The Central Bank of Iran is rolling out reforms to the structure of the financial and economic sector. Money and Credit councils will be split between their monetary policy function and their supervisory function in order to better manage risks to financial stability. A "toxic bank" will be set up to spare the banking system from its troubled assets and balance sheets. Credit cards will be significantly expanded, given the benefits they pose to consumers and businesses. Online banking will be aggressively pursued, having fallen behind the rest of the world as a result of financial sanctions. The Central Bank is also working with government to manage the provision of greater government lending for fiscal stimulus, such as the recent campaign to provide car loans.

Despite the recent, historic successes in the diplomatic arena, expectations for the Iranian economy are still framed by the risk of the deal falling apart. The JCPOA is a live-agreement, meaning continued compliance on all sides is required to keep it from going into reverse. The Iranian elections will be sharply observed by the investment community as an indicator of the openness and transparency of post-sanctions Iran, which reads directly across to the business environment. The types of investment Iran wants in oil and gas infrastructure, transport and the automotive industry cost billions of dollars, and few big corporations will be willing to risk losing money if the political environment is non-conducive or if the nuclear deal looks unlikely to hold. Foreign banks in particular remain worried about US sanctions related to terrorism and human rights that remain in place. The large and opaque footprint of the IRGC in the economy mean it remains very difficult for foreign firms to know when they are at risk of falling foul of US sanctions.