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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

issue 67 February 2017

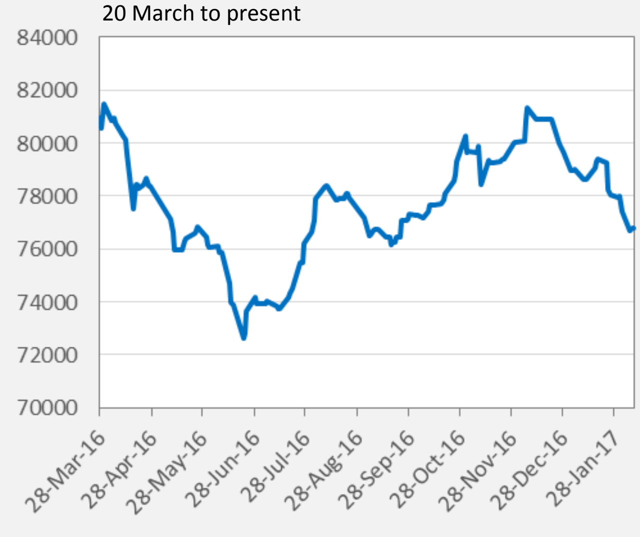
Reforming the state-sector is the key to economic progress

With Presidential elections fast approaching in Iran, the electorate will be faced with a choice between continuity and change. To its credit, the Rouhani administration has laid a solid foundation for economic progress with the JCPOA and rational policy making; but the failure to reform and privatise the state-owned sector holds the economy back. This will be crucial to fighting corruption, attracting foreign investment and reducing unemployment in the next four years.

When President Rouhani makes his pitch to the Iranian electorate for a second term in office, he will be judged not just on his striking of the JCPOA deal, but also his administration's ability to capitalise on it: on the latter his scorecard is mixed. The Rouhani administration can be credited with achieving what the President himself refers to as the "*return of tranquility*" to the Iranian economy. This is thanks to a commitment to delivering a disciplined, technocratic economic policy and the successful ramping up of oil production since sanctions were lifted. The economy is expected to grow 7% this year, with inflation likely to be held to single digits for the second year in a row. Mr Rouhani's key weakness going into the election is his lack of progress on unemployment, which is virtually unmoved (according to official statistics) since the start of his term at around 12%. Youth unemployment is even more troubling, in the region of 30%. The Imam Khomeini Relief Foundation said this month that if the poverty line is considered as a minimum wage of 820,000 tomans per month (~$250), then 11 million Iranians are struggling in poverty.

Mr Rouhani promised to flush corruption out of Iranian institutions and privatise state-run enterprises: his failure on this account creates a strong feedback loop into the underperforming economy. The government's 6th five year development plan, published last year, sets out to underpin high levels of GDP growth with "efficiency improvements", which it hopes will account for 2.5% growth per year. For a long-stifled economy like Iran's this is feasible, but unfortunately the administration has not worked hard enough to remove the barriers that stand in its way: most prominently the monopolistic position of state-owned and state-affiliated firms in key markets and corrupt practices that suffocate innovation and productivity. The government's spending priorities should be on long-term infrastructure investments: fixing water shortages, transport and communications infrastructure and improving the ease of doing business. Instead the lion's share of public spending is still tied up in military spend, subsidising consumption, capitalizing failing banks and propping up inefficient state owned enterprises.

Fig 1. TEDPIX All Shares index
20 March to present

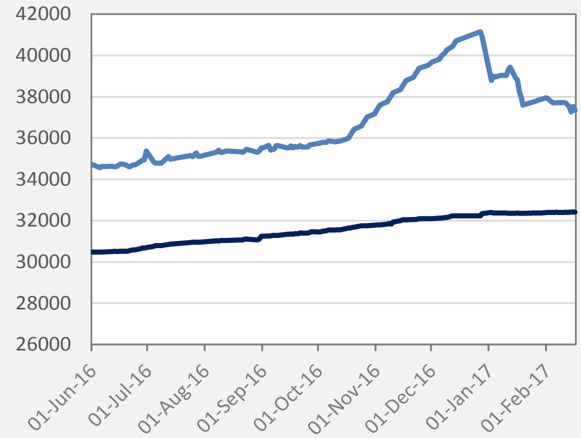


@VerityIran contactus@verityiran.com

Economy Minister Ali Tayebnia denounced the incumbent heads of state enterprises this month for resisting reform and privatisation and slowing down Iran's economic progress. The minister claimed that state companies had grown synonymous with rentier incomes, foreign travel, corruption and nepotism: "instead of hiring 1000 people, they will hire 5000 to do the same work." And this acts as a drag on productivity for Iran's most critical sectors. Tayebnia called for more public scrutiny of the behaviour of state-owned and quasi-state owned enterprises, which account for three times more than the overall government budget from the public purse. Perhaps that is on the cards for the next administration.

Fig 2. Rial to USD exchange rate

Official rate (dark) and market rate (light)

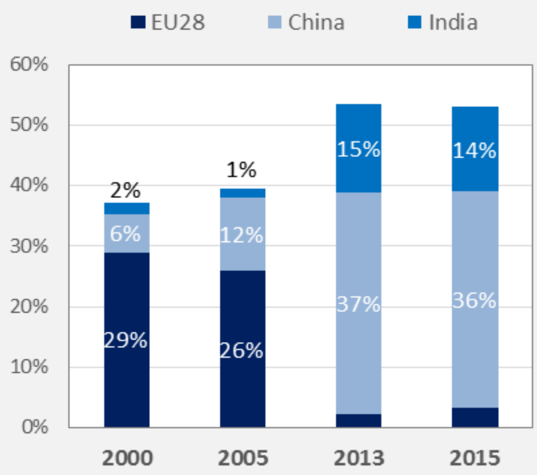


More often than not it is the state-owned sector which is the international face of Iranian enterprise, and this acts as a drag on foreign investment. Reporting by international news agency, Reuters, suggests that of the nearly 110 agreements in principle – worth a potential $80 billion – that have been struck since the JCPOA deal in July 2015, 90 have been with companies owned or controlled by state entities. Five of those went to conglomerates or foundations whose leaders Khamenei directly appoints, from railways, to oil refineries, pharmaceuticals and construction firms. Four of the deals involve firms in which the Islamic Revolutionary Guard Corps (IRGC) has a large or controlling stake. Many foreign businesses are eager to enter the Iranian market but highly nervous about who they are getting into business with, and the process stagnates. Foreign investors want to see a healthy, thriving private sector in Iran and if they see that, they will invest in it.

In President Rouhani's Norwuz address, he referred to the "pathway" he has laid out for the Iranian economy and argued for patience with long-term policies to make it a success. Certainly, the Rouhani administration has a solid track record in its commitment to the long term goals of the JCPOA and Iran's role in the global economy. It has also demonstrated success in economic policy, with a competent handle on interest rates, inflation and the exchange rate, and has laid the foundations for the difficult task of banking and financial sector reform. If the Rouhani "pathway" can lead to genuine progress on privatisation and the modernisation of Iranian economy, then it may well bear fruit over the next four years.

Fig 3. Iran's evolving trading partners

(% of total goods exports)



In other developments, Russia and Iran have been in talks over a medium and long term roadmap for bilateral cooperation, with Russian energy firms discussing a 100kbpd oil supply agreement and development partnerships for 11 Iranian fields worth over $20bn. Obviously, if Russia is serious about the investment this is a welcome opportunity from an economic standpoint – Gazpromneft, Rosneft and Gazprom bring large amounts of capital and technological know-how to production. But with Russia's growing presence in Iran and a blossoming economic relationship with China - China's share of Iranian exports has grown from 12% 10 years ago to 36% today (Fig 3), there is a risk of over-concentrating Iran's trading relationships, which could be unsustainable.