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No conspiracy: Foreign investors need greater assurances

Under increasing pressure to deliver on the benefits of the JCPOA, key figures have begun to deflect blame outwards towards interference from the US and "Iranophobia" amongst European banks. On the contrary, it is the pace of reform within the Iranian banking and business environments that will dictate the flow of inward investment. Foreigners are put off by the role of the state and the risks of doing business and it is within Iran's power to create the conditions for sustainable long term growth.

Three months on from 'Implementation Day', the JCPOA is not delivering fast enough for some critics of the Rouhani administration. Business delegations continue to fly in from across the world, Memorandums of Understanding are signed, hands are shaken and projects planned, but as yet virtually no concrete direct investment has materialised on the ground. Similarly, Iranian banks are liberated from financial sanctions but are slow to reconnect with their former financial networks. The CEO of Iran's Middle East Bank predicted it would take four or five months yet, mid-summer at least, until his bank was in a position to deal properly with international partners.

Fig 1. Tehran Stock exchange (TEDPIX All Shares Index)

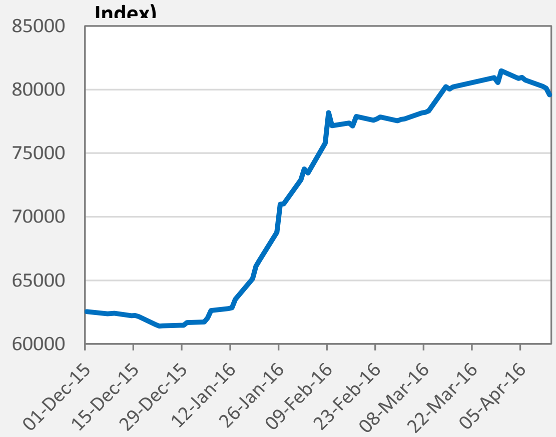
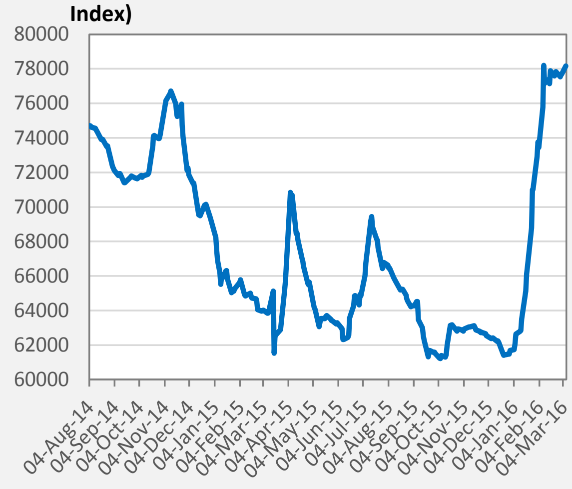


Fig 2. Tehran Stock exchange (TEDPIX All Shares Index)



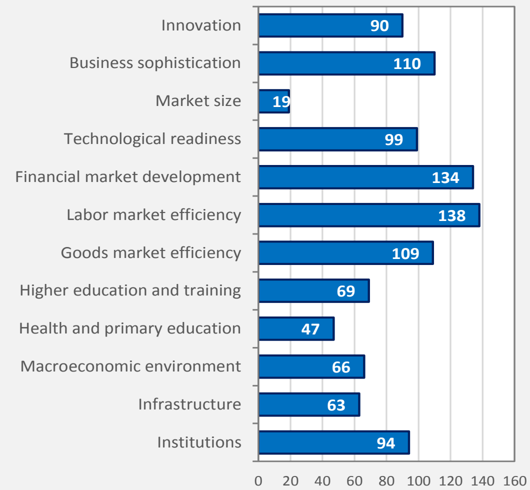
Sceptics have blamed the US authorities for discouraging banks and companies from engaging with Iranian entities. Key figures in the Iranian Finance Ministry and Central Bank lament the caution displayed by European banks in particular, which one described as "Iranophobia". They claim the concerns held by foreign entities are groundless or come from a lack of knowledge about the annulment of sanctions. The view amongst Verity-Iran's own network of contacts does not substantiate this.

There is no conspiracy. Foreign entities interested in Iran are generally making a calculated decision based on risk and reward, and the obstacles to doing business in Iran remain prohibitively high. As a general rule, foreign enterprises do not like take on risks outside those presented by their own industry, over which they have some control. In Iran, foreign investors must also weigh up currency risks, interest rate risks and most importantly political risks on top. The vested interests of "hard-line" political factions in the commanding heights of the economy, the armed forces and the judiciary, and the extensive and opaque business empire of the Revolutionary Guard (IRGC), all adversely affect the risk calculations of potential investors. Look at the international benchmarks many rely on to inform their judgement. Iran ranks 171st from 186 countries in the global economic freedom index, which is below even the Middle East and North Africa average. Iran ranks 83rd out of 144 countries in the World

Economic Forum' Global Competitiveness Index. This includes a 128th place ranking for financial market development, and 142nd place for workforce development. Foreigners are put off by the State's large and opaque role in the economy, a lack of confidence in the rule of law, a secretive banking sector, creaking infrastructure and meddling institutions.

Fig 3. Global Competitiveness Index 2016

World Economic Forum



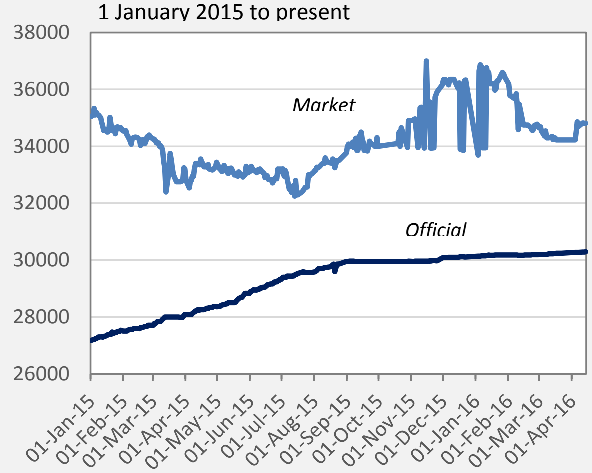
To the Rouhani administration's credit, these shortcomings have been acknowledged and there is a constructive strategic agenda in place to tackle them. It cannot proceed quickly enough. Finance Minister Ali Tayenbia has stated clearly that his ambitious plans for 5% GDP growth in 1395 are dependent on reforms to the many laws that detriment business and disturb foreign investors. The government has also put plans in place to broaden the tax base, reduce tax evasion and close down loop holes, as well as leveraging fiscal policy to incentivise the private sector. The Iranian Finance Ministry is now providing a 50% corporation tax break to any foreign investors building factories in Iran and exporting at least 20% of their outputs, hoping to attract international firms to Iran to establish an export hub.

Let's be clear about the scale of the challenge facing Iranian industries in attracting foreign capital and know-how. The government had plans in place to attract $30bn in foreign direct investment in the wake of sanctions relief. If this were spread over two years, it would be equivalent to around 4% of GDP. In 2014, FDI amounted to 0.5% of GDP according to World Bank data, and in the three year's prior has averaged around 0.6%, so that's a seven to eight-fold increase required in direct investment.

The Central Bank of Iran also has a crucial role to play in overcoming investor caution about the Iranian business environment. The CBI's success in reining in inflation has stabilised the economy in the short term, but for sustainable long term growth, Iran needs to transition from an opaque and inefficient bank-based economy to a more sophisticated market-based economy. Last year only around 3% of financing needs were serviced by the capital markets, compared to 90% from the money markets and the rest from the stock exchange. As the capital market deepens through the availability of more extensive and diverse financial instruments, the private sector will be stimulated, state monopolies will be eroded and capital will be allocated more efficiently to its most productive end.

Fig 4. Iranian Rial to USD, dual exchange rates

1 January 2015 to present



With the JCPOA in place, manageable levels of inflation and the promise of a more stable financial and business environment, the CBI believes the conditions are finally right for a unification of Iran's dual exchange rates. The CBI has claimed this will happen in the second half of the current Iranian year, a claim that has been made numerous times before. But if the authorities can finally achieve this, it will make a significant contribution to the rebalancing of the economy by removing inefficient subsidies and blocking off what has been a major channel for corruption and graft.