

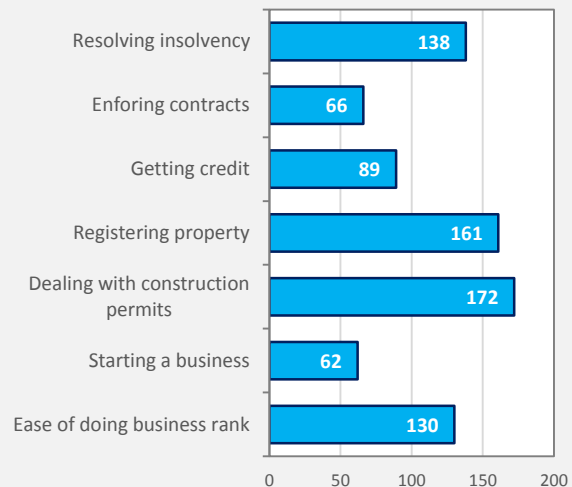
Is Iran ready for its nuclear dividend?

A growing sense of hope and optimism can be felt in Iranian business circles this month about the prospects of economic revival in the Islamic Republic. As the 30th June deadline for nuclear talks looms closer, so the press coverage swells, and it has been the business news largely setting the narrative: visiting business delegations, trade talks, post-sanctions investment advice. Iran is apparently set to receive a substantial “nuclear dividend” from the deal. Such preparations fuel business confidence in the short term and will provide a competitive edge should sanctions be lifted, in what is sure to be a frenzied environment. But without that deal on the 30th June, all this preparation will come to naught. Not only will the constraints on trade and investment with Iran remain in place, the economy will be at risk of plunging into a fresh financial crisis as business confidence quickly evaporates.

The sanctions regime facing Iran is sophisticated, multi-layered and far-reaching, but there are two key components causing the majority of economic pain: they are the US Treasury sanctions against NIOC and the CBI. These two listings do the most to restrict Iran’s oil sales, which remain the life-blood of the Iranian economy, and to block international financial transfers to Iran from any jurisdiction in the world. For all the promise of fresh investment in a resurgent Iran, as long as those two pillars of the sanctions infrastructure remain in place and well-policed, businesses will stay away.

Even in the event that Iranian negotiators secure a deal on sanctions-lift at the end of this month, the economy will still face significant challenges in the short and medium term: unemployment, poor standards of living and a lack of productive investment. The government’s Labour Market report this month states that five million Iranian households are now without a single bread-winner. And this measure of unemployment does not count the millions of underemployed in Iran – where an individual is counted as “employed” in the statistics even if he or she works only 1 hour a week (and where the female participation rate is particularly low). The Labour Minister pointed out that with 2.6 million new job market entrants each year, *five new workers per minute* are competing for scarce jobs. With regards to investment, regardless of the accessibility of funds, the complex and restrictive rules and regulations that inhibit foreign investment in Iran will not change overnight in the wake of a deal. The ban on bank accounts for those holding foreign passports, the inability of investors to inspect the firms they want to invest in, the poor communications infrastructure at the stock exchange,

Fig 1. Iran: Ease of doing business
(Source: World Bank)



will all continue to inhibit entrepreneurship. Fig 1 shows Iran's dire performance in the World Bank's Ease of Doing Business rankings, ranking 130th overall.

Pessimists also point to the risks that sanctions-relief will bring.

A flood of imported goods will drive unproductive and outdated Iranian producers out of business in the manufacturing sector. The diminished state of consumer finances after years of austerity will pour cold water on dreams of a consumption-led recovery. Some question the value of the contribution that foreign investors might make if that investment is skewed towards short term hot money flows into the capital markets, rather than much needed, long-term direct investment. What's more, rational investors will not rush into long-term partnerships in this environment, so soon after the signing of such a complex and fragile deal. The risk of sanctions "snapping-back" will take time to disperse and there will be a considerable time-lag for the banking sector in "white-listing" formerly sanctionable customers.

The stock market has resumed its declining trend this month, having swept away the signs of optimism that followed April's framework agreement. The TEDPIX lost another 4.5% in value in the month of May (Fig 2). Positive indications emerging from nuclear talks this month will begin to reverse that trajectory and there will be a dramatic surge in stocks if a comprehensive deal is announced and sanctions are lifted on Iranian banks. If Iran's isolation from the international financial markets could be overturned, Iran's stock exchange would indeed offer some of the world's hottest bargains. The top 100 firms in the TEDPIX are trading at around 5.1 times their annual profits, compared to 20.4 in Saudi Arabia and around 15 in most developing economies.

The foreign exchange market has had a steady month (Fig 3), with the gradual depreciation of the official rial rate bringing it closer to the market rate. If the authorities can successfully reduce that gap and eventually unify the two exchange rates, it will be highly beneficial in terms of reducing the liability of a very burdensome exchange rate subsidy for the government, and reducing the graft and corruption that has characterised the dual-rate era. A steady exchange rate over the past year has certainly been an important factor in the government's successful battle against inflation, via the price of imported goods. Should bad news in the talks cause the market rate to once again collapse, one can expect a resurgence of inflationary pressures.

Oil prices dipped again slightly (Fig 4), but even in its depressed state, the oil sector continues to represent the "size of the prize" for the nuclear deal for Iran. Fig 4 offers a reminder of the sheer scale of the drop in oil sales that occurred between 2011 and 2013/14, as sanctions on Iran's energy sector intensified, costing Iran revenues of up to US\$60bn per year. However, turning that latent export potential into revenues in the event of sanctions removal will not be straightforward, for a number of reasons. The absence of investment and advanced technology has left much of the sector in a state of ill-repair. The oil

Fig 2. TEDPIX Stock index
(August 2014 to present)

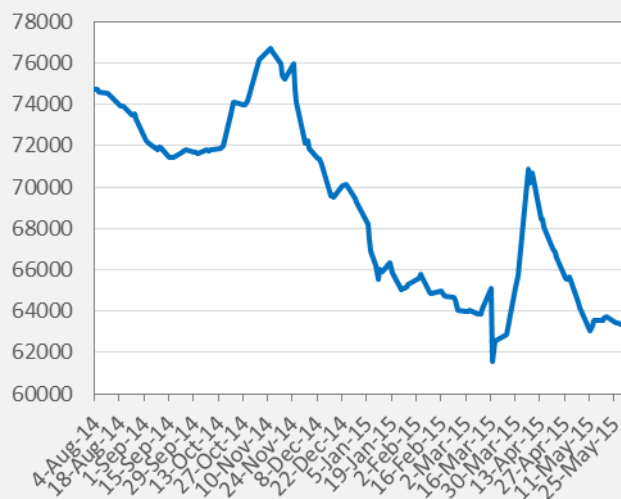
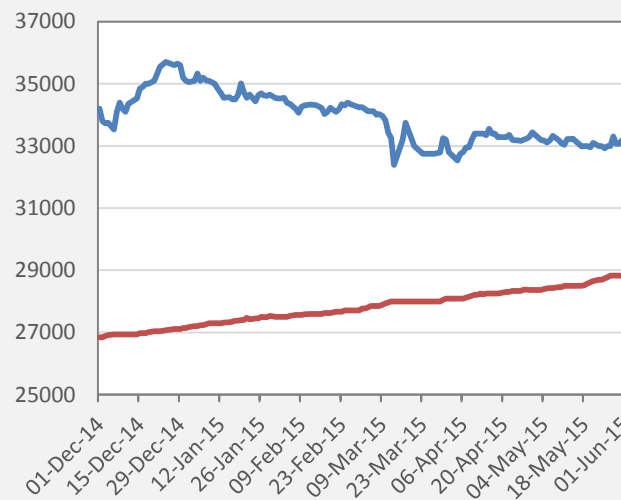


Fig 3 Rial:USD exchange rate (market and official)
(December 2014 to present)



ministry is seeking billions of dollars of investment and drawing up new, favourable terms for foreign investors, similar to oil production sharing contracts that were hitherto unheard of in the Islamic Republic to make up for it. Indeed Iran's oil and gas reserves are tantalising to the world's oil majors. But, with a break-even price of around US\$120 per barrel for the construction of new wells in Iranian oil fields, bringing new wells on-stream will remain prohibitively expensive for the foreseeable future. Besides, in the last three years Iran has lost its high price as well as its market share. Living up to NIOC's regular claim that it will quickly boost crude oil exports by 1 million barrels per day will be challenging, especially if it undermines global prices.

Iran received the last of its seven instalments under the JPOA

arrangement this month, making a total of US\$4.9 billion in permissible transfers from overseas accounts. This money provided a vital injection of funds into public coffers in the past six months, and has fed into the economy via public investment. A withdrawal of that funding will now in itself pose a shock to growth and carry other grave risks. During Ahmadinejad's two terms in power, the state of government finances became inextricably linked to the health of the banking sector, as state owned companies treated banks as their personal slush funds, crowding out the private sector from the credit markets. The number of non-performing loans soared and but for some creative accounting and state guarantees, much of the banking sector became effectively insolvent. It has now been revealed that the majority of Non-Performing-Loans in the sector can be traced back to no more than 500-600 individuals or entities, who owe over US\$10 billion of debt, and the main

problem is the government or state-owned enterprises. This giant hole in bank balance sheets is filled by short term borrowing from the Central Bank and is the most significant source of liquidity growth, and hence a driver of inflation. As a result, Iran finds itself in a situation where a cash-flow crisis in government and a failure to service state debts will very quickly translate into instability in the banking system and further inflationary pressures.

Water shortages are becoming increasingly acute across the country, and this too constitutes a crisis in need of urgent attention and investment. Iranian crisis management officials this month listed 520 cities facing drinking water shortages and the Energy Minister (with a water portfolio) announced that the countries reservoirs are 60% empty. He blamed the crisis on climate change, frequent droughts and most of all careless consumption. The highly wasteful agricultural sector consumes more than 90% of supplies.

Fig 4. Brent crude oil price (\$pbl) January 2014 to present

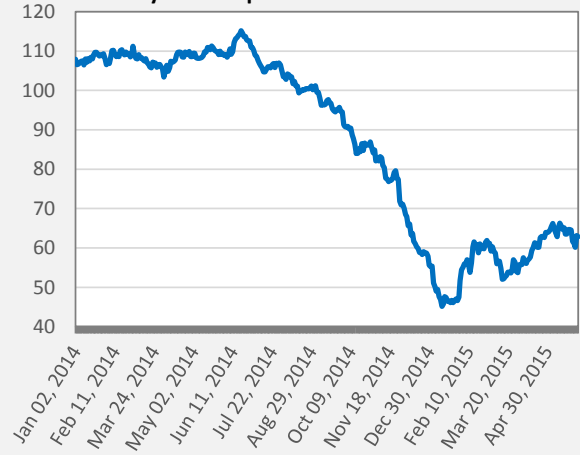


Fig 5. Iranian Crude Oil production, annual (2000-2013, thousand bpd)

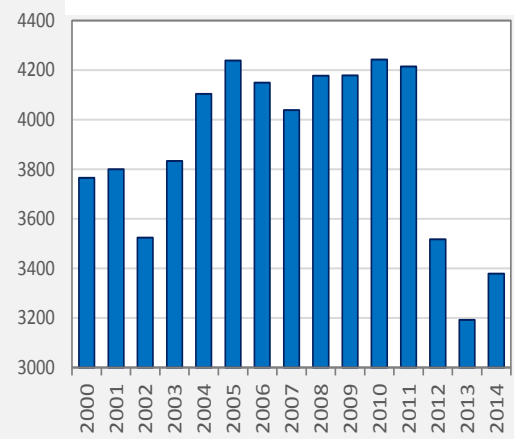


Fig 6. Iran's water crisis 1975 vs 2015

