

Iran economy awaits its rewards

Many Iran-watchers have been surprised by the subdued market response to the 14 July nuclear deal. A deterioration of the TEPIX all-share index and lacklustre rial have meant expectations of a short term kick to business confidence have failed to materialise. But there is good reason for the dip, and VerityIran still expects the boom to follow as long as Iran and its Western partners can follow through on the conditions of the Lausanne deal.

The month long drag on the Tehran stock index has deflated some expectations but it is important to remember that the deal is not yet complete and the obstacles to financial engagement are so far still in place. The TEPIX all-share index has dropped more than 5% in value since the 14 July agreement (Fig 1). Albeit an historic turning point, the signing of the agreement does not in itself produce any new capital or economic stimulus for Iran. Complex legal and technical processes are underway in the United States, the European Union and the United Nations to unravel the sanctions framework and deliver the agreed sanctions relief - as long as the technical conditions of the Lausanne agreement are met. But those processes are still in their early stages. Sanctions relief is still yet to come.

Market analysts also point, more soberingly, to the fundamentals driving poor stocks performance. The sub-par performance of the metals, petrochemicals and construction industries have weighed on sentiment. Rouhani's economic advisor, Torkan, has drawn attention to a severe recession in the construction sector where output dropped 65% this year. Add to that the low crude futures prices as well as the continued uncertainty in the European economy and the slow-down in China, which are affecting stocks globally. Economists are increasingly expecting the rewards of the nuclear deal to appear gradually for Iran, and in the medium term.

As the prospects for re-engagement become a reality, foreign investors are increasingly cognizant of the risks of participating in the Iranian economy. European companies have voiced concerns over the potential "snap-back" in US Congressional legislation and the liabilities they may incur. Other companies have been put off by

Fig 1. Iranian stock exchange (Tepix All-share)

04-May-15 to present

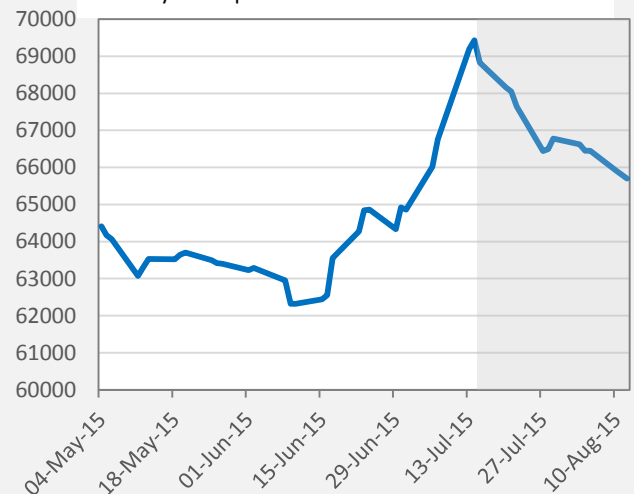
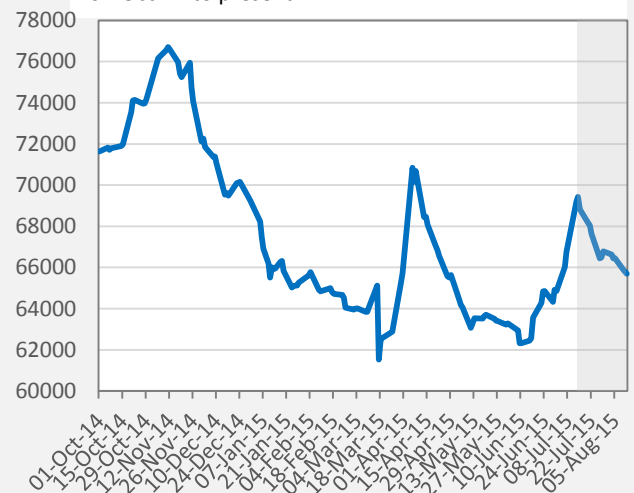


Fig 2. Iranian stock exchange (Tepix All-share)

01-Oct-14 to present



the complex legal and business terrain that remains. With the IRGC and its affiliates deeply embedded in the Iranian economy, investors worry about their exposure to the US Anti-Terrorism Act. Apart from that, level-headed, large Western institutions are aware that it is still early days for reconnecting with Iranian partners. The CEO of German Commerzbank suggested it was premature to talk about entering the Iranian market until the change in sanctions legislation was set in stone. The CEO of a Lloyds of London insurers, Beazley, also stated publicly that more clarity was needed before business could be done.

The Central Bank (CBI) Governor has renewed his commitment to unify Iran's two exchange rates within the next 8-10 months. This will be particularly important to prospective foreign investors looking for a stable economic environment. The rial has been steadily weakening since the deal, with the market rate dropping 2.1% (Fig 3) and even the official rate sliding by around 1%. The trajectory of the official exchange rate since October 2014 (see Fig 4) suggests the authorities are gradually weakening the official exchange rate to bring it closer to the market rate as a basis for unification.

A positive consensus is growing around the medium term outlook for the Iranian economy. A recent World Bank report forecasts a jump to 5% GDP growth in 2016 if the deal is completed, up from 3% this year. The report predicts a fall in the costs of doing business and a US\$17bn expansion in exports in 2016 (equivalent to 3.5% of GDP) as well as \$3bn of foreign direct investment, which is double the current figure but still only one third of the 2003 peak. The report points to the automotive and pharmaceutical sectors as major beneficiaries.

In determining the future of the Iranian economy, the baton now passes from Rouhani's diplomats to his economic team. So far, the administration appears to be preparing itself for much needed economic reforms. A bill is being drafted to open the Iranian banking sector to foreign participation – allowing foreign banks to open branches without having an Iranian partner. A new Integrated Petroleum Contract is expected to be introduced in December 2015, offering more favourable terms for foreign investors such as exclusive rights to exploration, development and production operations. Economy Minister Tayb-Nia has said the government will use sanctions relief as a platform to tackle the economy's deeply embedded structural problems. He has talked of making the most of foreign investment and the private sector, especially in the area of exports, and has committed to a continued effort to fight inflation until it is firmly in single-digit territory.

The macroeconomic environment will remain a key determinant of Iran's medium and long term success. Iran's battle with inflation is by no means over. The CBI reported a reversal in trends that saw month-on-month inflation rise 0.7% in June for the first time in over a year. The potential influx of capital and the boost to consumer confidence will present new inflationary pressures that could undermine Iran's recovery. The Iran Statistics Centre also released its long-overdue unemployment report in July, showing a slight increase from 10.6% to 10.8%. There are well-known weaknesses in the ISC's methodology, which neglects widespread levels of underemployment in the Iranian economy. Nevertheless, the figures do provide compelling insights. The rate of unemployment amongst women is twice as high as for men, and the rate amongst the young twice as high

Fig 3. Iranian rial:USD exchange rate
(market rate, 3-May-15 to present)

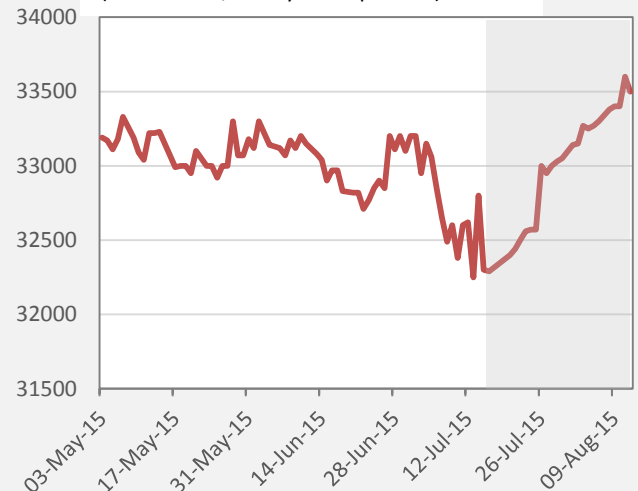
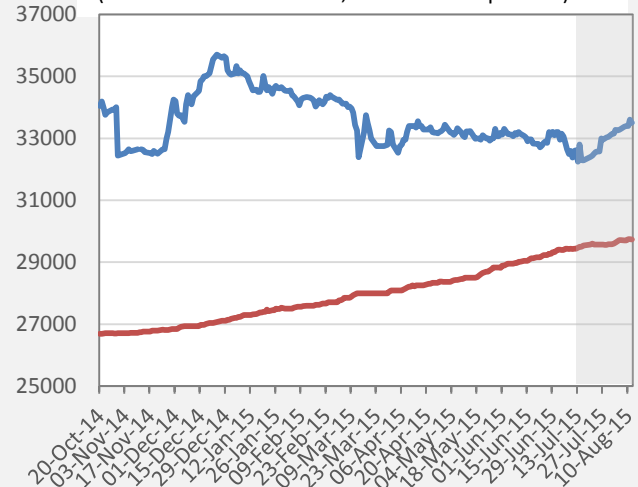


Fig 4. Iranian rial:USD exchange rate
(market and official rates, 20- Oct-14 to present)



as older workers. Perhaps a more telling statistic comes from the recently published CBI report on the family economy, which revealed a continued contraction in purchasing power amongst Iranian households in the past year. According to the CBI report, around *one quarter of urban households*, constituting 19 million people, have no employed household member. There is no doubt that despite the fanfare of the nuclear deal, the authorities face a significant challenge converting foreign investment and popular expectation into a sustainable job-creating economic recovery.



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