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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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Can Rouhani share the JCPOA's spoils in time for next year's election?

Historians may look back on President Rouhani's first term in office as one of major foreign policy wins and competent economic management. Still, if the administration is unable to share the dividends of that success with ordinary Iranian voters, it may have a hard time convincing them of the virtues of the JCPOA path. Success for Rouhani – and Iran —lies the way of structural reform, privatisation and effective action against corruption at the highest levels of the public and private sectors.

With nine months to go to the Iranian Presidential election, time is running out for President Rouhani to prove the value of the JCPOA to the voting public. The Rouhani administration's economic policies have established a stable macroeconomic trajectory for Iran, with low inflation, falling interest rates and improved exchange rate stability. The JCPOA deal has unlocked foreign trade and cross-border capital flows, which offer Iran the chance of an economic resurgence if they can be matched with much needed structural reforms. But delivering the latter is proving difficult and there is a risk that the benefits of the JCPOA are not reaching the pockets of ordinary working class Iranian families.

The latest figures suggest that the economy underperformed last year with GDP growth of 0.7%. Despite the "bounce" that was widely expected to follow the signing of the JCPOA, the economy could barely overcome the drag of low oil prices, a relatively tight monetary policy and subdued consumption and investment behaviour as individuals and businesses postponed spending decisions until after sanctions were eased.

In President Rouhani's favour, Iran's oil sector has quickly recovered market share, with exports now very close to the pre-sanctions level of 2.2 million barrels per day (mbpd). Crude exports averaged 2.1mbpd in June 2016, compared to an average of 1.25mbpd throughout 1394; oil output has jumped to 3.68mbpd in July from 2.9mbpd before sanctions were eased. For Iran to reach its stated goal of 5mbpd crude output, it will have to pour considerable resource into its neglected oilfields, which have been

Fig 1. Tehran Stock exchange (TEDPIX All Shares Index) Jan 2016 to present

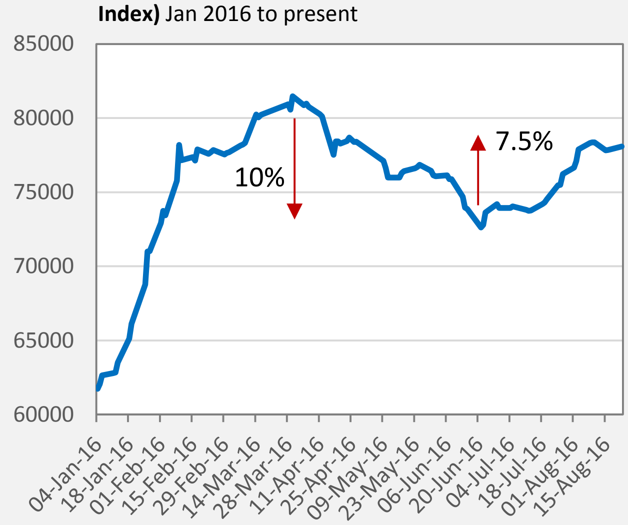
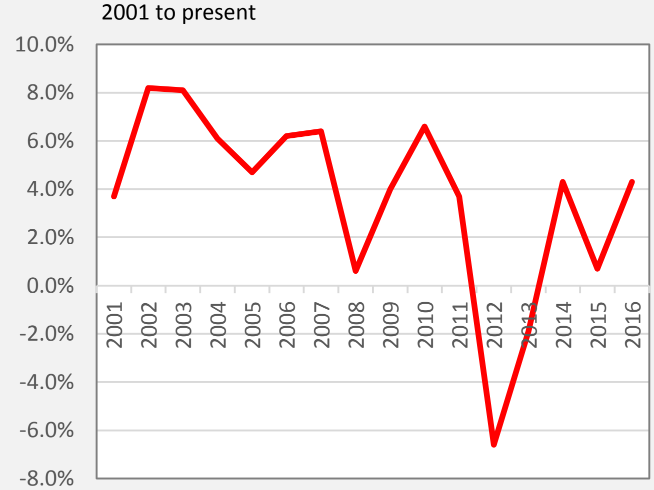


Fig. 2 Real GDP growth per annum, Iran
2001 to present

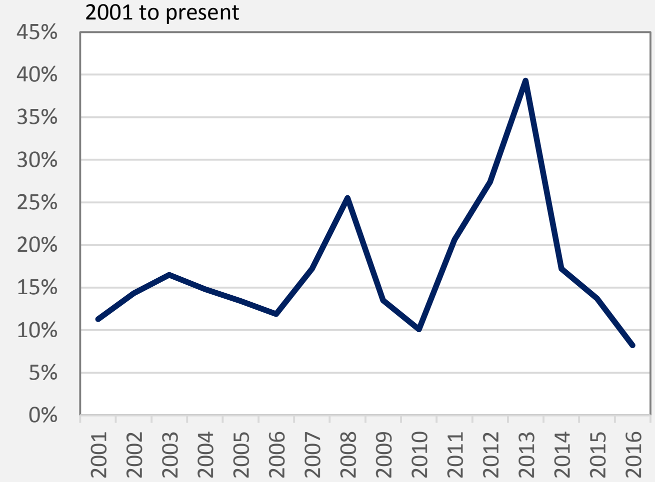


starved of investment for decades.

The new Iranian Petroleum Contract (IPC) was finally signed off by the cabinet this month after three years of discussions and will be vital to unlocking investment in the oil sector. The IPC has divided opinion in Iran over the degree of control it grants to foreign firms, but it is essential to securing much needed foreign investment. The contract has been designed to circumvent Iran's constitutional ban on granting mineral concessions to foreign firms, by guaranteeing compensation to foreign partners for their investment in crude oil development. Under the new deal, the National Iranian Oil Company (NIOC) has been able to set up numerous joint ventures for crude oil and gas production, which could lead to contractual agreements in the next six months.

Fig. 3. Inflation per annum, Iran

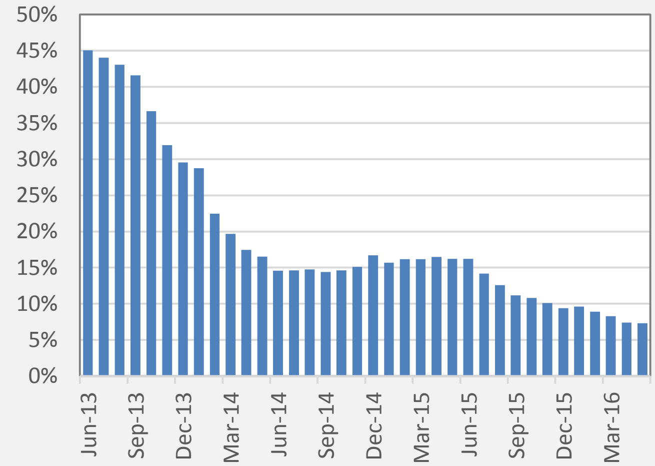
2001 to present



The Central Bank of Iran is making real progress towards its long stated aim of unifying the country's dual exchange rates. Historical bans on currency activities have been lifted and a new licence has been issued to banks to enable them to provide hard currency directly to customers. These developments reduce the risks to traders from engaging in overseas transactions and give them more confidence in depositing their hard currency earnings in the Iranian banking system. The moves also inject much needed competition into the forex marketplace, delivering efficiency savings to the economy and reducing the opportunity for graft. Previously, the only place for ordinary companies or individuals to purchase foreign exchange was on the "parallel market", which was dominated by powerful street money changers.

Fig 4. Monthly Inflation rate, Iran

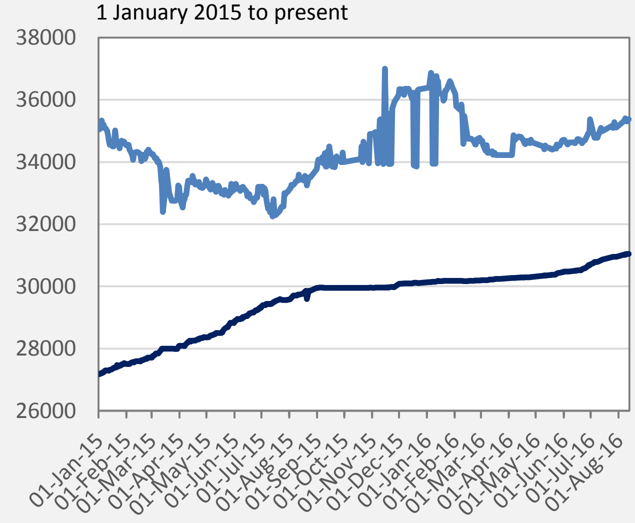
June 2013 to present



A recent study by the World Economic Forum found empirical evidence of the impact deeply embedded corruption can have on an economy as a result of the drag on company performance. The study found that bribery and perverse incentives led to an effective increase in operational costs for firms. This impairs growth at the macroeconomic level by leaking capital away from profitable investment and causing a drag on labour productivity, not least because employee talents are deployed to circumvent bureaucratic constraints rather than adding value to the company.

Fig. 5 Iranian Rial to USD, dual exchange rates

1 January 2015 to present



Iran bears the hallmarks of an economy under the strain of endemic mismanagement and corruption across both the private and public sectors. Recent scandals relating to extortionate levels of pay at the top of well-connected state-organisations have caused public upset over the inefficiencies and unfairness embedded in Iran's state-dominated economy. Such an atmosphere leaves a toxic impression on foreign observers too. Last year the World Bank ranked Iran 118th in the world in its corruption index. The IMF has advised that in order to attract significant flows of foreign investment, Iran must undertake serious economic reforms, including privatization, regulatory reform and market liberalisation.

Many commentators in Iran blame the US for Iran's stagnant economy, but to continue to blame external parties delays progress. Numerous high-profile politicians claim that US authorities have undermined the JCPOA by not doing enough to encourage international banks to engage with Iran. It is true that a cloud of uncertainty hangs over large international banks regarding dealings with Iranian partners. Banks must calculate the risks of sanctions "snapping back" into place if Iran reneges on its commitments, as well as any exposure to the remaining sanctions framework. But to continue to blame sluggish investment on external factors misses the point. Verity Iran's sources consistently point to the risks and uncertainties within the Iranian business environment as the chief cause for concern amongst foreign investors.

Iran's Energy Minster warned this month of the dangers of the country's imprudent and unsustainable water consumption and advocated price reform as the only solution. Water levels have reached alarming proportions due to rising temperatures and critically low levels of rainfall, as well as severe inefficiencies and a flawed tariff structure. Farmers pay barely 5% of the real cost of water, meanwhile wasteful and antiquated farming practices gobble up 90% of Iran's water resources. The World Bank ranks Iran as 24th most water stressed nation in the world and in some regions it has exhausted more than 86% of its renewable water resources. The Minister has set out to reform prices, stating that efficient consumption patterns cannot be achieved through bylaws, appeals and promotional work. The current condition will persist as long as prices are low.