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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

50 First posted: 15th September 2015

# Congress boosts Iran's economic outlook

*With the nuclear deal looking increasingly likely to secure its passage through the US Congress, the prospects of an Iranian economic revival are strong. The faltering stock markets tell a more nuanced story of business fatigue, falling oil prices and headwinds from China and Europe. But the "nuclear dividend" remains clear: Iran can expect a positive demand shock in the short term, a boost to financial stability and the opportunity for a long-lasting shift in the country's economic trajectory.*

***Investors can now look ahead to the next political hurdle.*** Eyes will turn to the Majlis discourse, and then Iran's work to implement the terms of the nuclear deal.

***Anticipation is growing amongst international and domestic investors about the practical significance of sanctions relief for the Iranian economy.*** Oil analysts are expecting Iran to quickly add between 600kbpd and 1mpbd to oil production next year, returning to 2011 levels. Players in the automotive, minerals and civil aviation sectors are preparing for large-scale investments. And more broadly, the fresh flows of capital, entrepreneurs and high quality inputs are expected to boost productive potential, as will the transfer of ideas and technical expertise. The Iranian administration's senior economic advisor, Mohammed Nobakht has said that even despite the slump in oil prices, he expects the boost from sanctions relief to deliver 5% GDP growth next year, rising from an expected 3% this year.

***This sense of enthusiasm contrasts sharply with the moribund mood of the Tehran stock exchange.*** Fig 1 shows how the confidence boost that surrounded the final days of the nuclear negotiation has been eroded since the deal was signed. The index has lost 10% of its value in the last 60 days and remains 12% lower than this time last year. The rial too has struggled against international benchmarks, losing 4% at the market rate and 2% at the official rate against the US dollar since the 14 July accord (Figs 3 & 4). However, it would be a mistake to interpret these signals as

**Fig 1. Iranian stock exchange (Tedpix All-share)**
04-May-15 to present

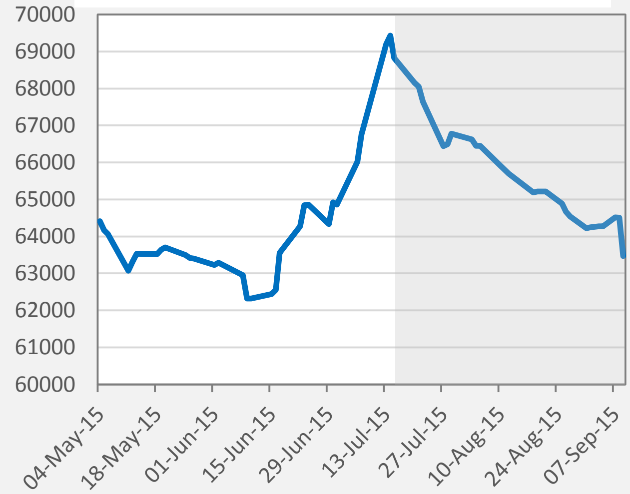
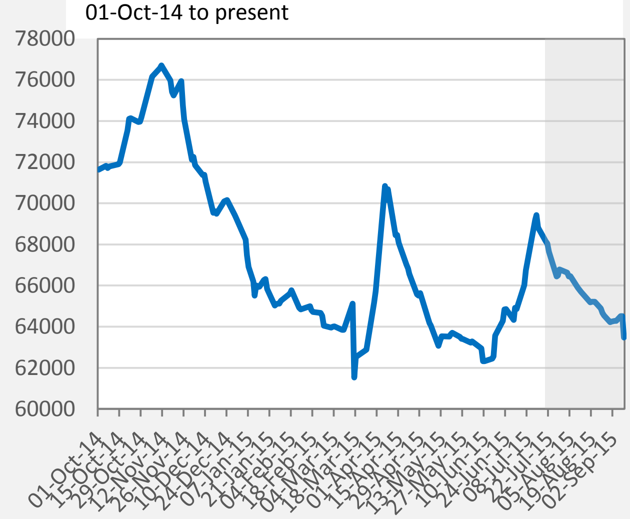


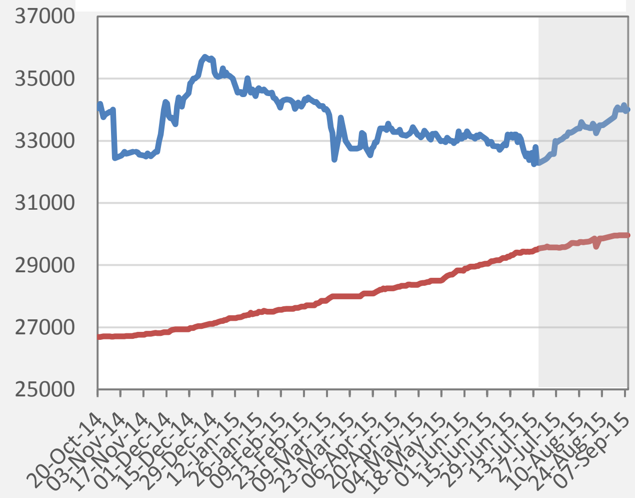

**Fig 2. Iranian stock exchange (Tepix All-share)**
01-Oct-14 to present



pessimism about the likelihood of the nuclear deal following through or indeed the prospects of sanctions relief thereafter. Rather, investor optimism for the deal is being offset by a series of strong counteracting forces.

***Iranian businesses are fatigued by years of hardship.*** Elevated costs of doing business, depressed demand and the lack of credit have characterised the business environment for the past 4 years. Businesses have accumulated large inventories and are struggling to service large debts. They know they are not out of the woods yet and this is weighing on market sentiment.

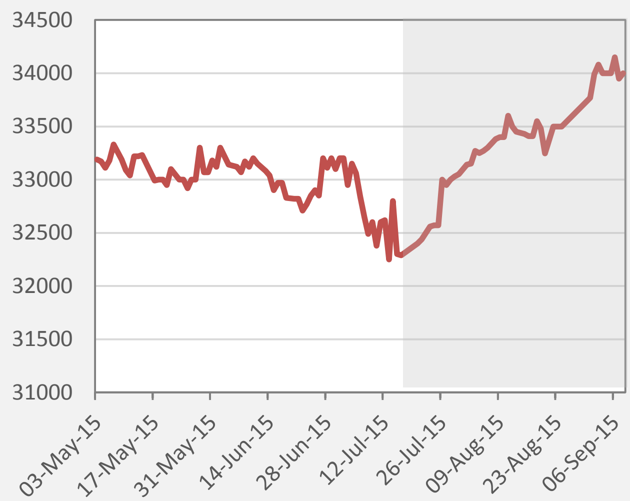
**Fig 3. Iranian rial:USD exchange rate**
(market and official rates, 20- Oct-14 to present)




***The unexpected drop off in oil prices has also taken its toll.*** Oil prices fell to a six month low this month, having lost a further US$8-10 per barrel since July and having halved since this time last year. This has clearly hurt revenues as well as placing a dampener on post-sanctions expectations. The government's budget was agreed on the assumption of $72 per barrel, which means a likely 3.8% fiscal deficit by the end of the year. This is the largest deficit since the Iran-Iraq war and the government faces the dilemma of printing money to fill the gap or diverting valuable funds from the private sector. Not to undermine its commitment to tackling inflation, the government has opted for the latter, which has exacerbated the credit-crunch faced by private firms.

***Investors are also cognizant of the macroeconomic headwinds that will be facing Iran by the time sanctions are lifted in 2016.*** Continued uncertainty in the Eurozone and China's faltering growth have weighed heavily on global stocks in the past month, and these risks will roll over into next year. A slow-down in China in particular will impact the price of Iran's hydrocarbons and minerals exports. What's more, the IMF has forecast a rise in Iranian inflation in 2016 meaning the government's options for fiscal stimulus will remain constrained.

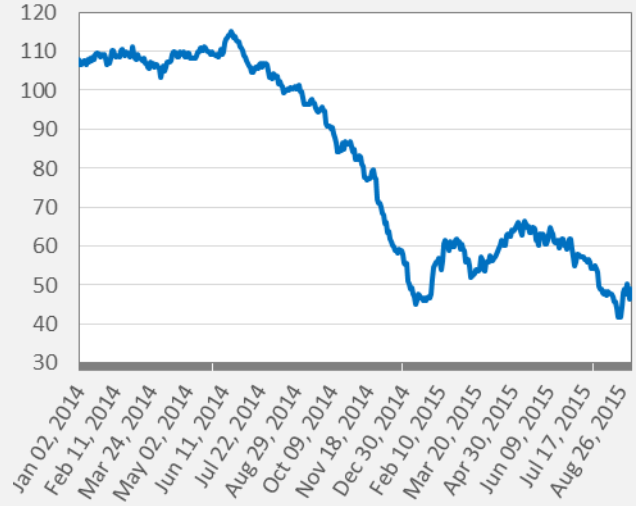
**Fig 4. Iranian rial:USD exchange rate**
(market rate, 3-May-15 to present)




***Nevertheless, investors have a clear eye on what the "nuclear dividend" might entail: a positive demand shock, a boost to the international reserve position, and the opportunity for a long-lasting shift in the economic trajectory.*** Estimates of the Iranian assets set to be released by the nuclear deal range from $150 billion to less than $30 billion. The latter is a statement from the Iranian Finance Minister, who argues that the majority of Iranian funds in overseas accounts are already accounted for or earmarked for collateral on joint investment projects. It is well known that the Indian authorities are under pressure to clear a $6.5 billion outstanding payment and that the UAE oil company, ENOC, owes over $5 billion. Anglo-Dutch oil company, Shell, has promised to clear its outstanding $2.3 billion payment as soon as it is able to do so legally. These payments will provide a windfall to government coffers, at least indirectly via the National Iranian Oil Company. The authorities will most likely use the funds to shore up their financial reserves for the time being, strengthening the economy's buffer against exchange rate volatility or indeed a banking crisis. Iran's large diaspora is likely to provide another source of funds – some analysts believe it add up to $20 billion more, and this is likely to have a more direct impact on economic activity.

***In addition to capital flows, Iranian industries are looking forward to a rapid expansion of exports as financial channels reopen.*** The international energy news agency, Platts, has estimated that Iran's off-shore hoardings now amount to 53 million barrels of oil and condensates, plus three tankers that "remain invisible". The potential windfall from the sale of these stocks will complement Iran's medium term plans to upscale production volumes, although the price risks of Iran's return to the market will mean they act cautiously. Iran's non-oil industries face no such risks and will take advantage of the cheap rial exchange rate to return their wares to international markets as quickly as possible in the next year

**Fig 5. Brent crude oil price ($pbl)**
**January 2014 to present**




***The responsibility for Iran's economic trajectory is in the process of transferring from foreign policy chiefs to economic managers.*** Rouhani's economic team does right to focus on improving the business environment and mobilising and empowering the private sector. The Ministry of Economic Affairs has published its plans to improve the country's "ease of doing business" rankings, following World Bank guidelines to address corruption and complexity in Iran's regulatory and legal systems. Iran expects to finalise its new model for international oil contracts this month, aimed at creating a more welcoming environment for foreign investors and engendering long term strategic cooperation with international oil companies. The new Direct Tax Law is designed to help address the country's endemic abuse of its tax system. Recent estimates suggest as much as half of the Iranian economy is avoiding the taxman, including many state-affiliated organizations. This suite of measures is a good start – although some analysts view the challenge of turning Iran's isolated, stagnant and inefficient economy into a vibrant emerging market is an impossible task. Let us not forget, the same was said of a negotiated nuclear agreement with the E3+3.