

Time to come in from the cold

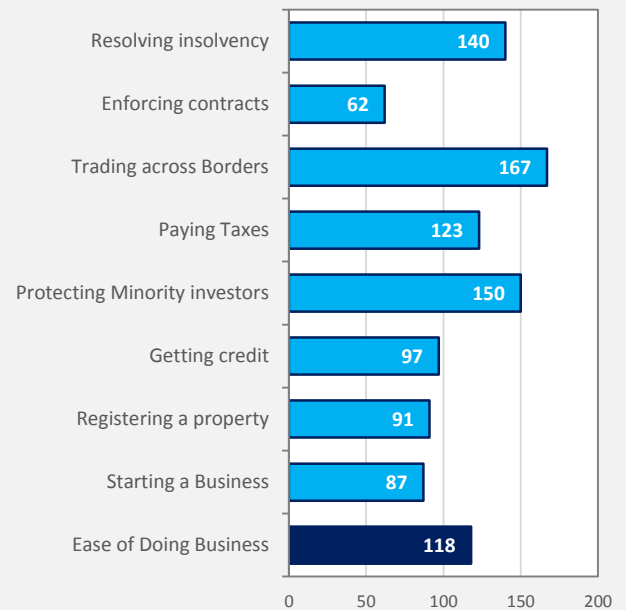
The IAEA's report on Iran's nuclear programme brings sanctions relief into view, with the JCPOA Implementation Day now a matter of weeks away. The economic opportunity is immeasurable, but success is not guaranteed. The risks to Iran's economic future have shifted to the domestic sphere. Verity-Iran highlights the failure to open-up, the frailty of the banking sector and over-extended government spending – perhaps even including the Syria conflict, as the new key risks.

The IAEA's positive report on Iran's nuclear programme has triggered the final phase of the Joint Comprehensive Plan of Action, with sanctions relief due in a matter of weeks. The US state department claimed that the report “adequately addressed the outstanding issue of past military dimensions of the nuclear programme”. The report now paves the way for the IAEA Board of Governors to officially close its investigation into Iran's nuclear past when it meets on 15th December 2015. At that point, the conditions will have been met for the long-awaited “implementation day” for the JCPOA. The EU, UN and United States are expected to suspend or terminate nuclear-related sanctions against Iran by early January 2016. The deal presents a unique opportunity to transform Iran's industries, upgrade the nation's infrastructure, raise the standard of living and jolt the economy onto a more prosperous and sustainable growth path.

Implementation day will be a watershed in Iran's economic history as the country's isolation from the global financial and trading system is reversed, but economic revival is not a foregone conclusion. Achieving it will require astute economic policy making and hard-nosed political deal-making, not to mention the unravelling of some stubborn vested interests. The main risks to Iran's economic outlook have now shifted from international barriers to domestic politics, which may prove even trickier to overcome. With sanctions relief obtained, Verity-Iran identifies three principle risks now facing Iran's economic future. They are the failure to open-up to international business, the frailty of the banking sector, and the over-extension of government spending.

Iran's immediate challenge is to manage the process of opening up and modernising the Iranian economy to compete with the world's advanced economies. Iran climbed twelve places in this year's World Bank Ease of Doing Business Index, but only to a global ranking of 118th. On a number of critical metrics such as starting a new business, getting credit, and resolving insolvency, Iran's global ranking actually worsened in the past year. Recent improvements to the terms of inward investment in the energy sector are a step in the right direction, as is the Rouhani administration's improved professionalism in its

Fig 1. World Bank Ease of Doing Business Index
Iran ranking across relevant metrics



management of national statistics and the economy, which reduce investment risk. But investors are put off by opaque ownership structures, the lack of a rule of law and the looming threat of sanctions “snap-back”. Corruption and cronyism are regularly reported as the main barriers to international firms and will require rapid action from the Rouhani administration if it is to deliver on its post-sanctions promises.

Opening up the Iranian economy will be a disruptive process, with losers as well as winners. Alongside the benefits of improved technology, innovative ideas and capital investment, there will be domestic enterprises unable to compete with more productive international competition and vested interests losing out to emergent entrepreneurs. Opening vested interests to competition and loosening the Revolutionary Guards’ grip on the economy is necessary. This process will be politically challenging but economically rewarding for Iran, especially over the medium and long-term. President Rouhani’s recent car-loan subsidy programme is an example of how easy it will be to get this wrong. Iran’s automotive sector is key strategic industry that has been starved of capital since 2011, in need of new technology, inefficient and producing sub-standard products for the domestic market. Subsidising and protecting domestic sales from such industries will only exacerbates the sector’s inadequacies in the post-sanctions era, storing up problems for the future and reducing the chance of international expansion. The ability of this sector and many others to embrace new technologies and adapt to new competition will determine the Iranian economy’s future trajectory.

Iran’s banking sector is also about to face international competition for the first time in years, posing major risks to the country’s financial stability. Iran’s isolation from the international financial system is acute. Fig 2 shows the difference in levels of cross-border financial claims in Iran, compared to other regional economies. The Central Bank of Iran will need to keep a very close eye on capital flight and solvency. Iran’s banks will have to quickly adjust to new standards for capital adequacy, corporate governance and transparency if they are to compete.

The banking sector will also have to get much better at delivering finance to Iranian businesses, especially small and medium sized enterprises if they are to have a chance of taking advantage of post-sanctions opportunities. The Central Bank has been unable to effectively stimulate new lending and clearly needs to undergo deeper reforms with regards to the way it conducts monetary policy. The Central Bank must embrace a more sophisticated set of policy levers to effect change in lending behaviour, for example becoming more actively involved in the money and inter-bank markets.

The banking sector’s vulnerabilities are inextricable from those of government finances. Bank lending have been squeezed by a dangerously large non-performing loan portfolio, officially worth over \$30bn, and excessive government borrowing. Government debts to the banking sector also stand at over \$30bn and the finance ministry is struggling to maintain them given the considerable squeeze on its own revenues from a desperately low oil

Fig 2. Foreign claims on domestic financial entities (USD bn, 2015)

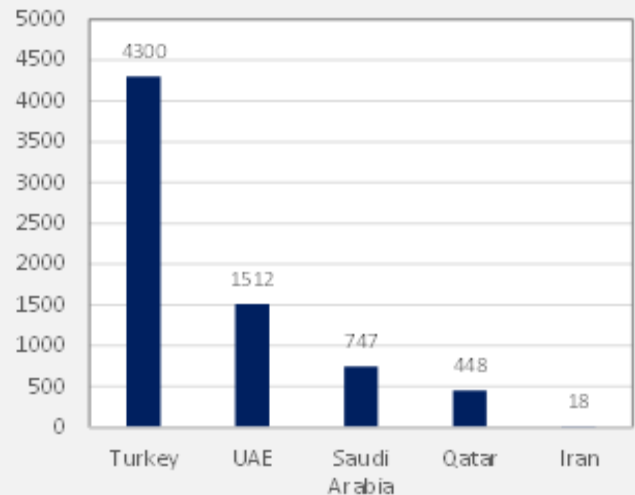


Fig 3. Brent crude oil price (USD per barrel, 1390 to present day)



price. The price of Brent crude oil has fallen from over \$130 per barrel in early 2012 to around \$45 per barrel in August 2015, a decline of over 60%.



price. Fig 3 offers a reminder of the fall in value over the past two years. Oil revenues in Iran are down to \$25bn this year, from US\$119bn in 1390.

Verity-Iran's analysts are concerned about Iran's continued involvement in the Syria conflict and its drag on resources. The objective of Iran's involvement in the conflict is a matter of foreign and security policy but it also has significant economic implications. Verity-Iran is aware of how expensive a lengthy campaign such as this, will turn out to be for Iran. This question is especially pertinent now that the involvement of other international parties in the conflict reduces Iran's own influence over its outcome. Certainly, the opportunity cost of Iranian funds spent in Syria has just risen as the opening up of Iran's economy means there are plenty of investment options at home that could deliver much greater returns.

Meanwhile, the markets continued to disappoint over the past month despite such positive news on sanctions relief. The Iranian business community suffered a psychological blow as the rial dropped below 36,000 per USD.

A less gloomy analysis would draw attention to the strengthening dollar as the rial's performance against other major currencies has actually been positive in the same period. Some economists argue that the legacy of multiple years of very high inflation mean the rial rate, despite its weakness, is still overvalued and with the government committed to unifying the exchange rate in the post-sanctions era it is advantageous for the real and official exchange rates to slide to their natural equilibrium. As Iranian businesses prepare to re-engage with the global economy after so long out in the cold, they will gladly accept a cheaper export price and more expensive imported goods to help them compete in the post-sanctions economy.

Fig 4. Iranian Rial to USD.

(Official and market exchange rates)

