

Reading Iran's Economic Indicators

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Introduction

Two important events have generated a psychological momentum in the Iranian economy, i.e. the implementation of the so-called Joint Comprehensive Plan of Action¹ (JCPOA) on 16 January 2016 and the twin elections that were held on 26 February 2016. The first event will pave the way for sanctions relief and the election results will empower the moderate forces in the Iranian political system to introduce the needed legal and structural reforms to improve the country's business climate.

In this article, I will take a closer look at the main economic developments in the country and will discuss the prospects of economic development in the next two years.

Latest Economic Indicators

Since the election of Hassan Rohani in 2013, the Iranian economy has changed gears and has moved from the recessionary years in which it experienced a peak 5.8% decline in 1391 (ended on 20 March 2013) into positive territory again. Nonetheless, low oil prices and continuing structural issues have pushed economic growth to about 1% in the Iranian year that ended on 19 March 2016, however, a growth of about 4% is expected in the new calendar year.

A closer look at key economic indicators in the last year as well as projections for the new calendar year (table below) underline some important trends.

Table: Key Economic Indicators

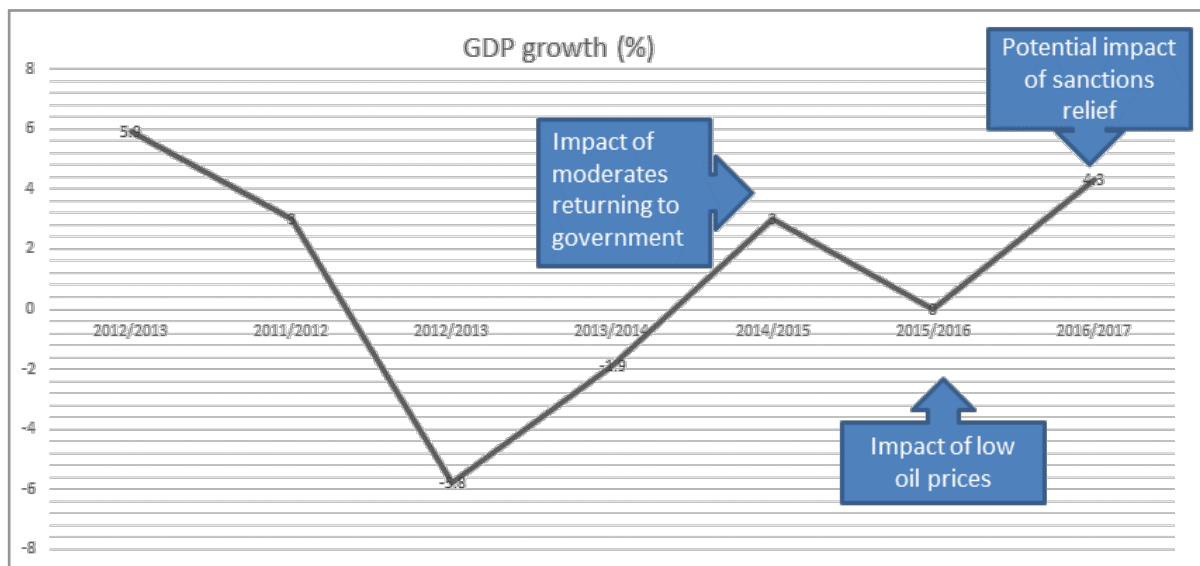
Indicators	1394* (ended on 19.03.2016)	1395* (ends on 20.03.2017)
GDP growth (real in Rial)	1.1%	3.9%
GDP (nominal in US\$ at median exchange rate)	\$360.7 bn	\$420.7 bn
GDP per capital (nominal)	\$4,576	\$5,269
GDP per capita (PPP)	\$15,572	\$16,023
Inflation (Official)	16.7%	15.9%
Oil and gas exports	\$56.0 bn	\$78.1 bn
Non-petroleum exports (including services)	\$44.8 bn	\$48.3 bn
Imports	\$68.3 bn	\$74.0 bn
Trade Surplus	\$21.4 bn	\$40.2 bn
Unemployment Official (Unofficial)	10.1% (16.0%)	9.7% (15.9%)
Capital account deficit (in US\$)	-1.0 bn	-1.0 bn

Main source: Iran Economics Magazine , January 2016 (Eqtessad-e Iran), * Projected

1| A term referred to the comprehensive nuclear agreement between Iran and the P5+1 (US, UK, France, Germany, Russia and China) which paves the way for the lifting of nuclear-related sanctions.

Iran's return to GDP growth is important as the country needs to address its core issue, i.e. unemployment. As the following graph indicates, annual growth will even increase further once external sanctions are lifted in the course of 2016.²

Graph: Iran's Annual GDP Growth (including projection for next year)



Source: Central Bank of Iran, Atieh International (www.atiehinternational.com)

As mentioned earlier, the Iranian economy has embarked on a new growth path. The lifting of sanctions and the fact that the country can export more oil and petroleum products will help sustain the growth path, despite the negative impact emanating from lower oil prices. Nonetheless, it is important to appreciate that the Iranian economy will not achieve the 8% annual growth in order to create the jobs that the country's young population needs. In fact, an 8% growth can only be achieved, if a long host of structural, legal and economic reforms are initiated and implemented as will be discussed later.

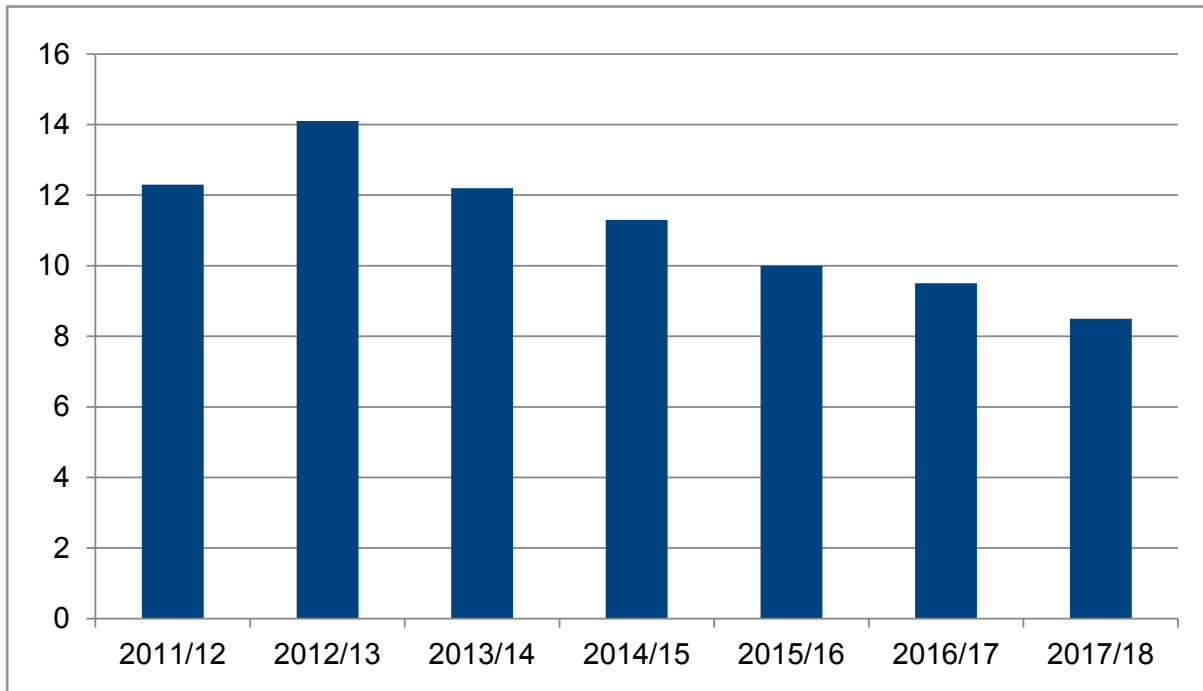
In addition to economic growth, one main strength of the economy is the sustainable trade surplus. In fact, the Iranian economy has managed to sustain its trade surplus over the past few years and all indications are that the trade surplus will increase now that most external sanctions have been lifted. Continued trade surplus will offer the Iranian economy an important backbone to face other economic challenges.

As the above table indicates, inflation and unemployment remain the key negative indicators in the Iranian economy. With regard to unemployment, the overall trends have been positive, but the country's young population will continue to put pressure on the job market. In fact, youth unemployment continues to be high and currently stands at 25%.³ In fact, according to official statistics 40% of Iran's university graduates fail to find a job in their own field of expertise – a phenomenon that is known as "underemployment". Considering the fact that the most important economic sectors that have the potential to create sustainable jobs will be the service sector, the government's success in reducing unemployment will depend on its ability to grow employment intensive sectors such as agriculture and services, especially tourism.

2| Through the implementation of the so-called Joint Comprehensive Plan of Action, all nuclear-related UN and EU sanctions as well as secondary US sanctions have been lifted, though the full normalization of trade and financial ties will depend on the resolution of some operational bottlenecks, e.g. in the banking sector.

3| Source: <http://www.tradingeconomics.com/iran/youth-unemployment-rate>

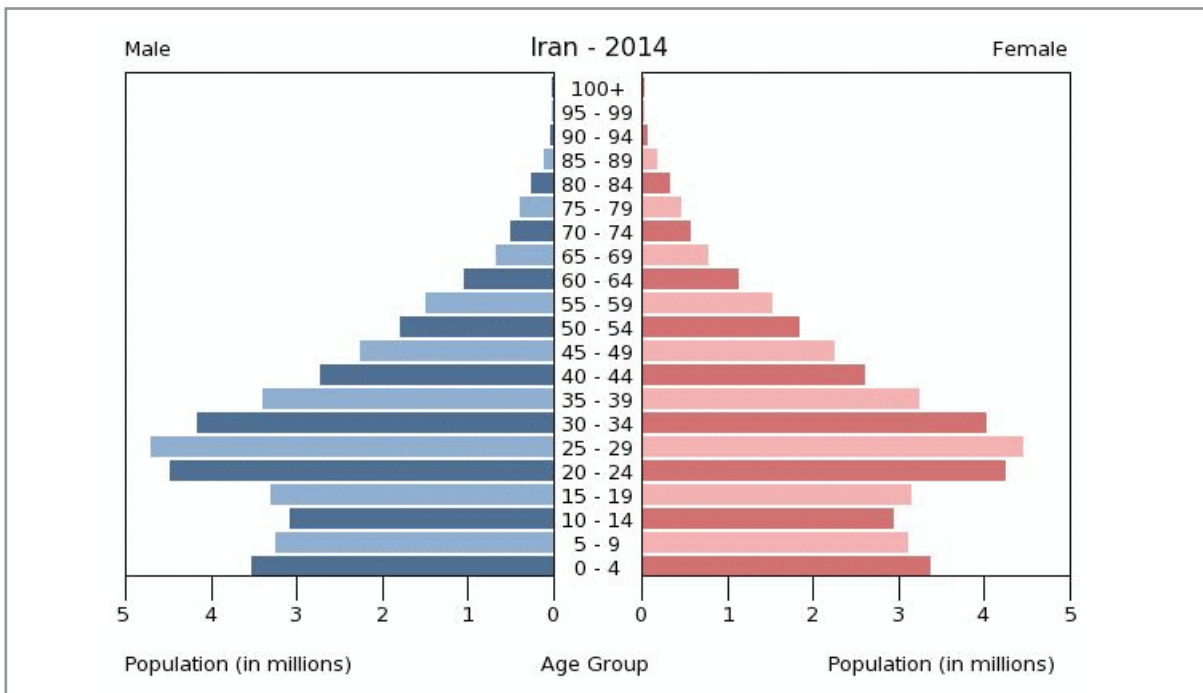
Graph: Unemployment Trends



Source: Statistical Center of Iran / Author's projections

The key socio-economic factor keeping pressure on employment patterns is the country's demographic profile which is depicted in the below graph.

Graph: Iran's Demographic Profile in 2014



Source: Statistical Center of Iran

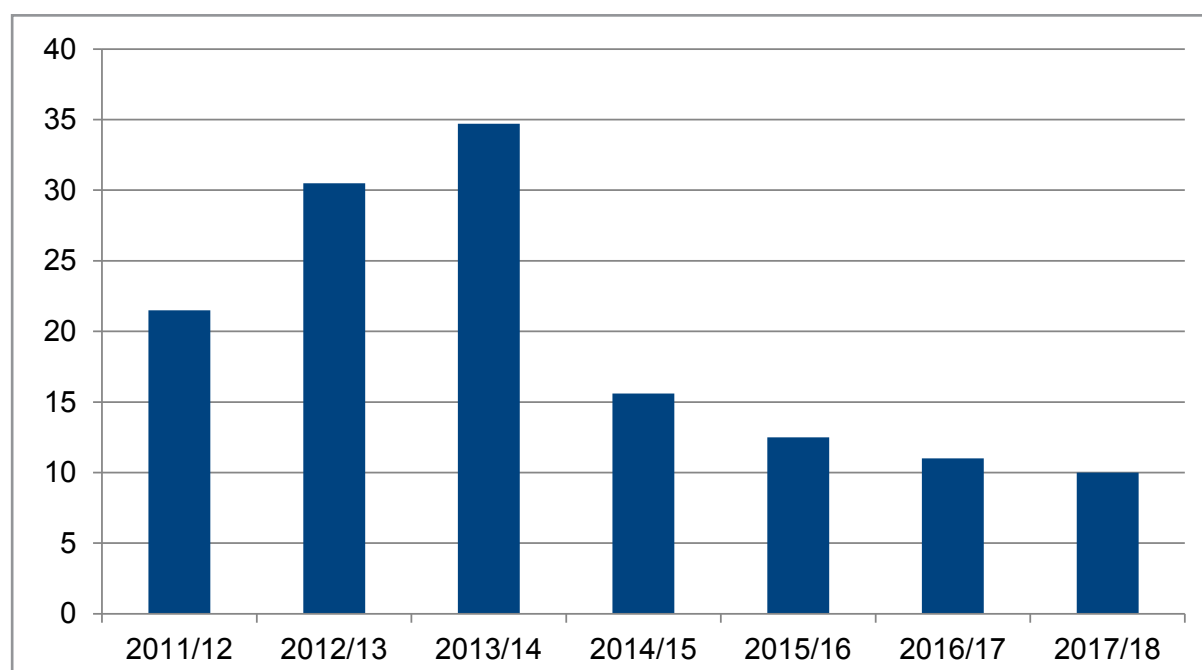
The other key challenge is inflation. Though the government has managed to contain the run-away inflation of the past few years (which had reached 42% in May 2013), the actual inflation remains high. Nonetheless, as the following graph indicates, the trend is positive and as of January 2016, the government had managed to reduce the 12-month inflation to below 15%. This is a major achievement that can be explained by the rela-

tive stability in the foreign exchange market as well as the government's attempts to increase non-monetary services (such as health services covered by state insurance) to the population. Though government officials are aiming to achieve a single digit inflation rate by March 2017, a number of drivers need to be taken into account in assessing inflationary trends in the coming years. These include:

- Lower than expected oil export revenues for the government will cause financial bottlenecks which will lead to government borrowing and potential budget deficits which will fuel inflation;
- The ongoing price increases within the subsidy reforms will also add to inflationary pressures. It is expected that the final phase of the subsidy reforms will be implemented in 2016;
- The government's plan to unify the exchange rates (see below) will also push up prices at some point in 2016;
- Relatively high bank interest rates (recently reduced to 18% on bank savings) will also contribute to inflationary pressures;
- The one factor that has contained inflationary impulses in the recent past has been a relative stagnation in the housing market. However, the lifting of sanctions may lead to a new level of transactions on the property market that could also unleash inflationary pressures.

In addition to the above facts, economic development in Iran is also partly carried by what economists call "illusory inflation", i.e. an expectation of inflation which in itself causes further inflation. Another factor that will make single-digit inflation difficult, is the fact that the government will have to engage in expansionary policies to stimulate the economy. One such example was the recent granting of loans for car purchases that in itself will led to inflationary impulses. Notwithstanding, if the government manages to sustain an inflation rate between 10 and 15% and in parallel to introduce needed structural reforms as well as lower interest rates, inflation may fall to new lows by 2017/2018.

Graph: Iran's official Inflation (including projections)

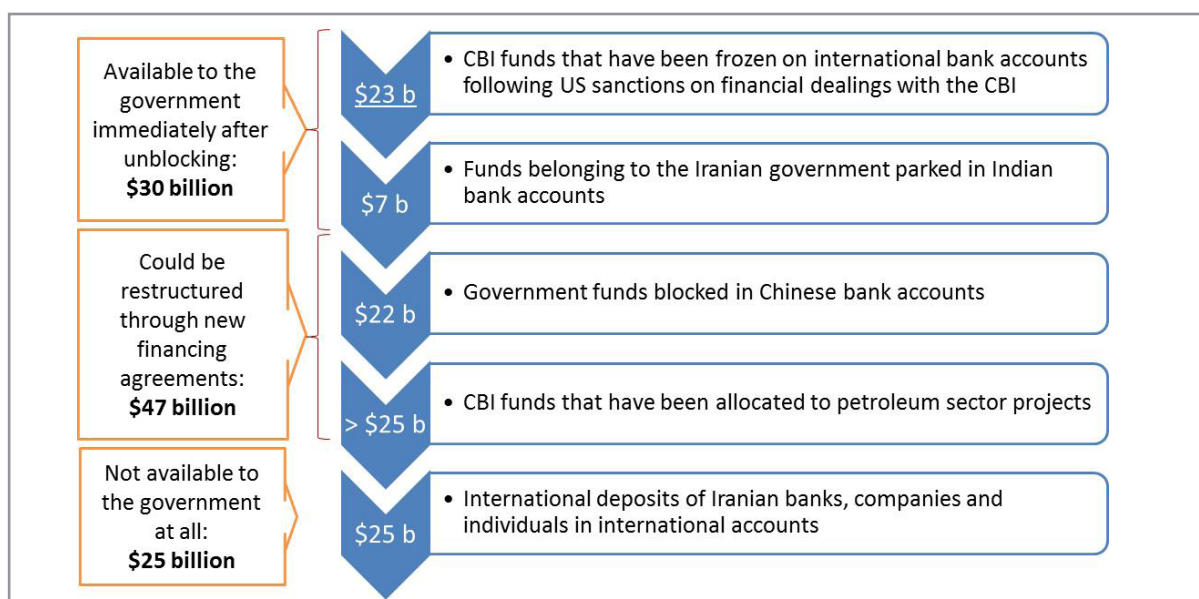


Source: Central Bank of Iran / Author's projections

The Government's Financial Position

One of the phenomena that will have an impact of the Iranian economy in 2016, will be the recent unfreezing of sizable Iranian assets in international banks. In fact, more than \$100 billion of Iran's international assets have been unfrozen after the implementation of the JCPOA. However, as the following table indicates, only about \$30 billion of these funds will be available to the Iranian government immediately after their release. One major block of these funds, i.e. Iran's hard currency funds on Chinese banks and those that have been allocated to petroleum sector projects can only be used through relevant restructuring as they have already been used as collateral for financing of existing projects.

Table: Availability of Iran's Frozen Assets



Source: Central Bank of Iran / Author's compilation of various statements

Nonetheless, the availability of some \$30 billion will also ease some of the financial pressures on the government and it will probably use the released funds to restore a more balanced economic development, most importantly settle some of the government's accumulated debts to its subcontractors, banks, power plants etc. The repayment of some old debts will partially vitalize the economy and help it grow.

Evidently, low oil prices and other structural issues have already limited the government's financial capacity. The dependency of state budget on oil revenue has fallen from 50% in 2013 to about 30% in 2015 and probably to 25% in 2016⁴. As such, privatization and tax revenues will be the more significant sources of income for the government leading to an attempt to increase tax revenues – itself a new irritant on businesses.

Already struggling financially due to low oil prices and economic challenges, the Iranian government will also use the new momentum to issue domestic and international bonds to finance its infrastructure investments. At the same time, the most important impact of low oil prices is the government's desire to empower the private sector as the main engine of job creation & economic value-added activities. These pull-and-push effects will continue to irritate the Iranian private sector until the economy finds a new "post-sanctions" balance.

4| The state budget for the new Iranian year had not been passed at the time of drafting this paper, but based on the government's budget bill, dependency on oil revenues will fall to 25%.

Exchange Rate Developments

One of the policy areas that are subject to the complexities of the Iranian economy is the exchange rate policy. Expectations were that the nuclear agreement and the eventual lifting of sanctions would actually strengthen the Iranian Rial, but both the free market rate and the so-called forex chamber rate (official banking rate) have increased leading to the gradual devaluation of the Iranian Rial. Fact is that the Central Bank of Iran (CBI) continues to manage the exchange rate through its regulation of the currency market. The volumes that the CBI injects into the market have a major impact on the actual free market rate and all signs are that the Rial will gradually be devalued to create a new balance in the economy. In fact, a number of leading actors in the Iranian business community opine that the Iranian Rial is currently overvalued and that a devaluation will be in order in 2016.

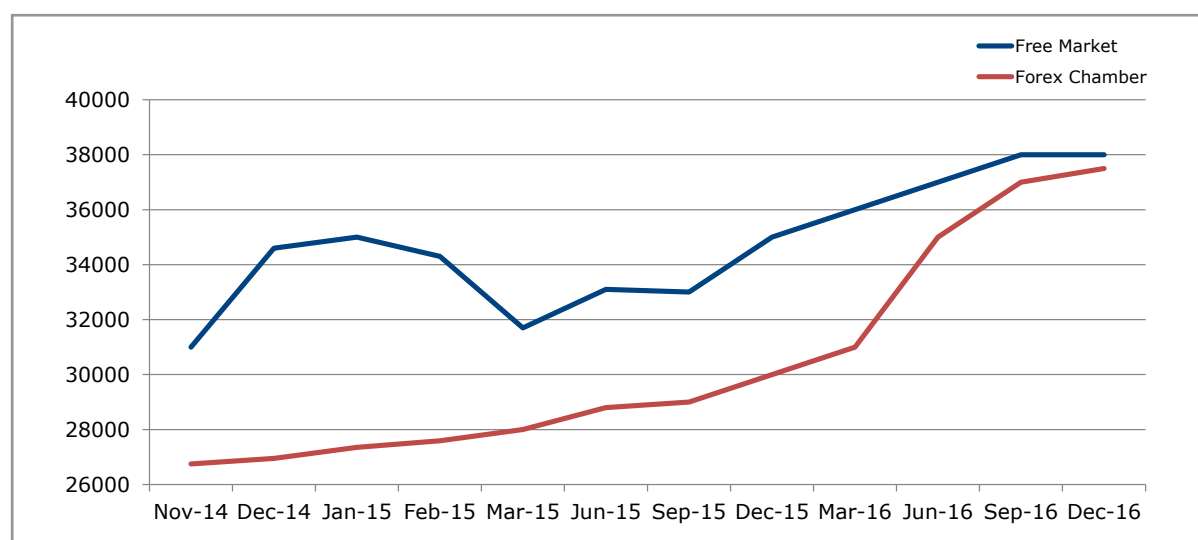
To gauge the real value of the Rial, we could look at the Iranian currency's position since 2012, when the "forex chamber rate" was introduced. In fact, in October 2012, the official rate was around Rial 11,000 to the US\$ (an artificially kept rate) and then the CBI introduced the forex chamber rate at Rial 25,000 to the US\$. If we use this rate as a basis and then use the inflation differential as a methodology to determine the exchange rate, then we would get to the following picture.

Table: Theoretical Value of the Iranian Rial

	Oct 2012	Oct 2013	Oct 2014	Oct 2015	Oct 2016
Exchange Rate	25,000	33,375	38,448	43,754	48,567
Inflation in Iran		35%	16%	14%	12%
Inflation in the US		1.50%	0.80%	0.20%	1%
Inflation Differential		33.50%	15.20%	13.80%	11%

This means that the Rial remains overvalued and that the CBI intervention will be the main instrument to keep a lower rate. Nonetheless, the CBI will also be under pressure to allow market forces to have a more determinant role on the Rial exchange rate. As such, we expect that the Rial will be devalued gradually. There is also a plan to unify the exchange rates in the second half of 2016. Therefore, we foresee the following exchange rate development in the next 12 months:

Graph: Foreign exchange rates: Moving towards Unified Rates



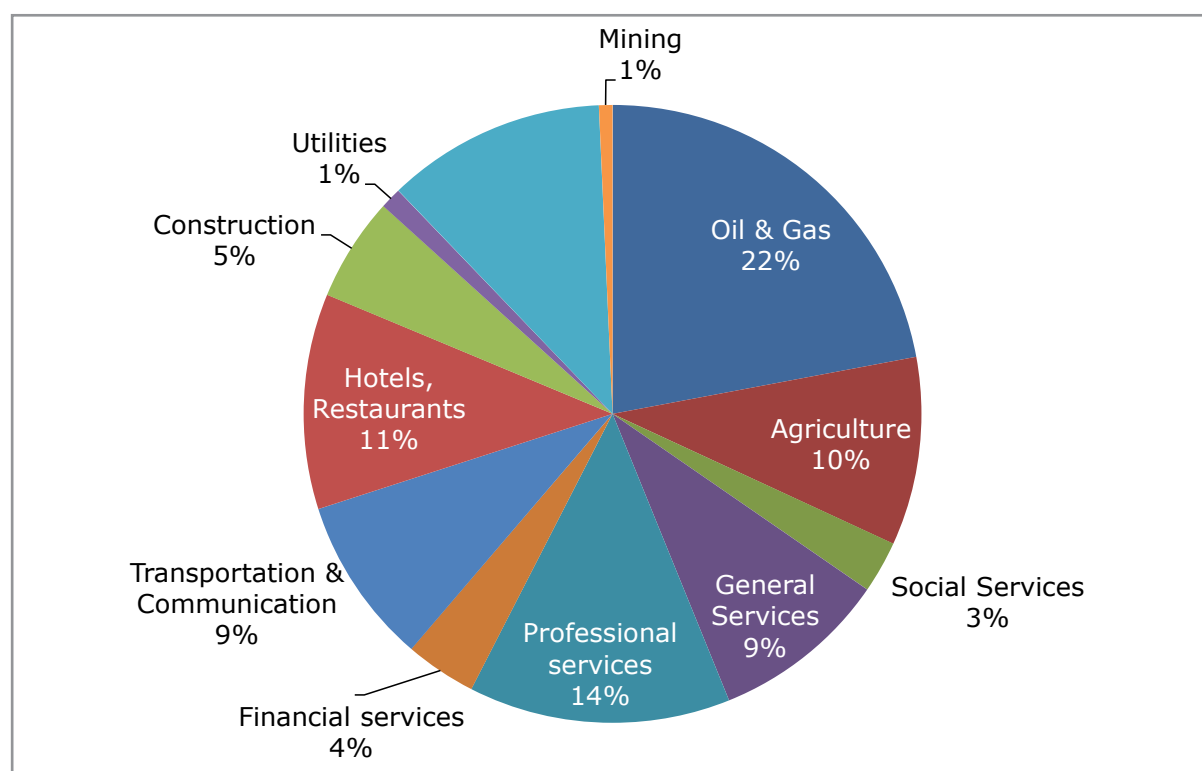
Source: Central Bank of Iran / Author's projections

Iran's Trade with the World

In the past Iranian year, the non-crude oil trade surpassed \$112 billion with some \$50 billion in non-crude oil exports. Adding about \$50 billion in crude oil and gas exports, the country has achieved about \$162 billion in foreign trade. There is no doubt that foreign trade will grow significantly now that external sanctions have been lifted. On the one side, Iranian importers will look forward to importing needed goods, machinery and services directly and without legal and financial hassles and on the other side, the country's exporters would be able to look to new markets and opportunities. The overall import volume (about \$60 billion) may not increase dramatically because some of the additional cost (which was related to sanctions) would be eliminated in a sanctions-free environment. However, Iranian exports will rise and will further consolidate the country's economic future.

Within this context, it is important to appreciate that the Iranian economy has diversified enormously over the past decade. As the following graph indicates, the composition of the Iranian GDP is diversified with a large segment of the economy being service driven.

Graph: Composition of the Iranian GDP (2014)

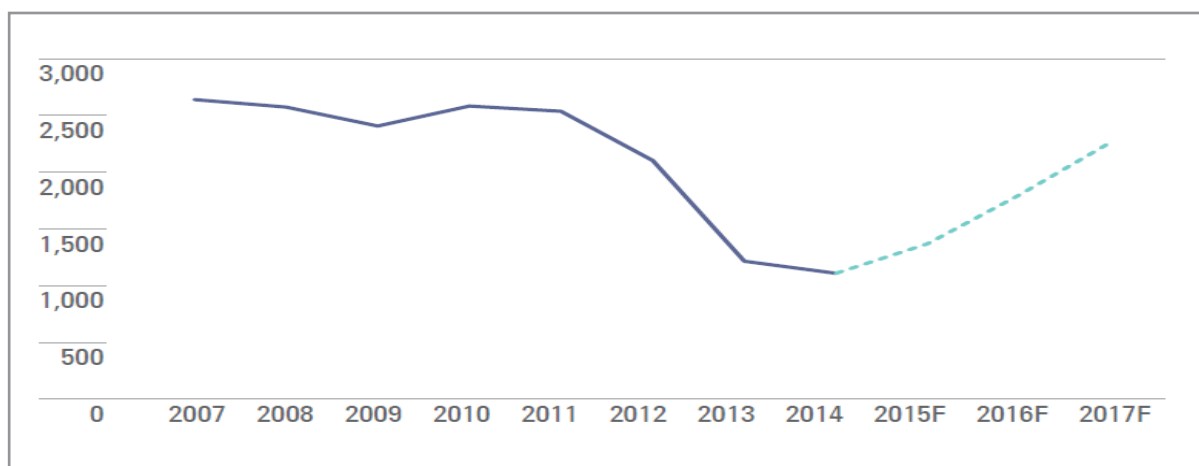


Source: Statistical Center of Iran

One path of increased export performance will be additional oil production and exports. In fact, as of early March 2016 Iran had already added some 500,000 barrels per day (bpd) of oil exports compared to the period before the lifting of sanctions.⁵ As the following graph suggests, Iran will be able to return to its previous crude oil exports level by 2017, i.e. exporting about 2.5 million barrels per day (mb/d) of crude and condensate which would represent about 1.2 mb/d more than in 2015, i.e. an added annual income of about \$20 billion at current prices.

5| Source: <http://www.presstv.ir/Detail/2016/03/09/454734/Iran-oil-exports-sanctions-NIOC-Javadi>

Graph: Outlook for Crude Oil Exports (in '000 barrel per day)



Furthermore, gas production will benefit from the availability of new technology and equipment from western companies. Iran has managed to increase gas production despite the sanctions regime, but a lifting of sanctions will accelerate the production increase. Higher gas production parallel to attempts to increase energy efficiency will create future potential for gas exports as well as investments in gas-based industries. Hand in hand with growing gas production, Iran will also continue its strategy of producing more gas-based commodities such as petrochemicals, steel, aluminum, cement etc. which in turn will increase the country's export potential.

Business Climate

One of the key issues in materializing the genuine potential of the Iranian economy will be the overall investment climate, especially the issue of corruption. Officials at all levels have admitted openly that financial and administrative corruption exists and that more needs to be done to fight this phenomenon. President Rohani has even gone as far as declaring corruption as a national security threat stating that "the continuation, the deepening and the expansion of corruption is endangering... the Islamic Revolution."⁶

By elevating the issue to a national security threat, Rohani is opting for a more intense momentum in the fight against corruption, though the overall political structure will make the fight very challenging. President Rohani views lack of transparency, inappropriate laws and regulations as well as the accumulation of power in some entities as the main causes of corruption. His remedies include increased transparency through e-governance, breaking monopolies, reforming relevant laws and regulations as well as engagement of civil society and the media. Interestingly, all top level political figures are talking about the need for increased transparency and for empowerment of the private sector. However, the track record of the past decades indicates that the real private sector remains hesitant to enter into competition with large governmental or semi-state organizations. Consequently, a push to downsize the government would usually lead to an enlargement of the semi-state sector – itself a source of new monopoly situations that undermine the presence of genuine private sector players in the economy.

Consequently, the real campaign against corruption and the real process to improve the business climate would be the one that addresses needed legal, political and structural reforms. It remains to be seen if the Rohani administration will generate the political will to introduce the needed reforms now that the new Majles will be more moderate in its outlook.⁷

6| Source: <http://www.dailymail.co.uk/wires/ap/article-2865080/Irans-president-criticizes-widening-corruption.html>

7| The new Majles will convene in July 2016. Based on current projections, the moderates will be the largest faction, though they do not have a full majority. A cooperation between moderate and independent Majles deputies could produce the support that the government needs to introduce reforms.

However, all the calls for deregulation and promotion of private sector activity will be hampered by the fact that the government will remain the dominant investor in an economy that needs job creation and growth. Incidentally, the draft bill outlining the so-called 6th Five-Year Development Plan (April 2016 to March 2021) that has been presented to the Iranian Majles includes a number of objectives that touch on the issue of business climate. According to the Head of the Management and Planning Organization, Mohammad Baquer Nobakht, the plan foresees the achievement of the following objectives by March 2021:

- Improvement of income distribution and decreasing the Gini Coefficient to 0.34 as well as a single digit inflation rate of 8.9%;
- Unemployment rate of 7% from the current rate of 10.45;
- Iran's Doing Business Rank to hit 70 from the current rank of 118;
- Budget dependency on oil export revenues to decline to 22%, from the current rate of 31.5%.
- Share of tax revenues in the GDP will increase to 11.5% from the current ratio of 6.5%.
- Ratio of government revenues to expenditures will reach 105.6% from the current figure of 68.4%.

The plan also sets the objective of achieving 8% annual economic growth including a 2.5% growth through efficiency improvements – another objective that can only be achieved through giving more space to genuine private sector activity.

Overall Economic Outlook

It is clear that the implementation of the JCPOA as well as the shift of the political mood towards moderate forces have generated a momentum in the Iranian economy. Driven by the growth potential as well as greater levels of foreign investment and an anticipated growth in the presence of international, especially European companies in Iran, the Iranian private sector will also become more active in the next few months and years. However, the positive impact will be gradual, both due to the need for ongoing reforms as well as the overall ability of the Iranian economy to absorb foreign investment.

The good news at this stage is that the Iranian economy will attract a much wider scope of economic sectors to invest. Apart from oil and gas as well as key industrial sectors such as gas-based industries and the automotive industry, one can also expect a lot of foreign investment activity in sectors such as pharmaceuticals, FMCG, telecom as well as the sectors known as the "New Economy", i.e. IT and e-commerce.

What will be very significant for the attraction of major foreign investment, will be how the government improves the country's investment climate. In fact, from the perspective of international investors, political risk remains an important risk in Iran, therefore, as explained earlier the government engaged in a process of improving business climate as well as fighting corruption in order to attract foreign investment. Presently, government and private sector representatives are proposing remedies such as political and structural reforms as well genuine privatization, the promotion of civil society institutions (including an independent media), and the promotion of codes of conduct in the private and public sectors. However, this will be a long term process due to the complex political structure.

While the economy will be driven by its resource-based potential and the consequent investment opportunities, the most significant missing link will be financing of these projects. Tehran is looking to its international partners for financing solutions, however, there may be some limitations due to the hesitation of international banks to re-engage Iran as long as major US sanctions are in place.

Nonetheless, the lifting of sanctions will provide the economy as a whole with the necessary resources to push ahead with the needed investments. In addition to the unfreezing of international assets, Iran will also be able to export more oil which will further generate needed hard currency revenues.

All in all the outlook for the economy remains positive, however, the improvement will be very gradual and it will also be influenced by a number of domestic, regional and international developments including domestic balance of power, regional security issues as well as the future price of oil. Absent major political or regional upheavals, Iran could be transformed into an exporter of diverse products and commodities. However, as explained earlier, high inflation and unemployment will continue to persist in the following years due to structural and demographic realities.