

Iran: Back in the game?

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Executive summary

- The economy moved out of recession in 2014, so a modest improvement was discernible prior to the recent nuclear/sanctions deal. Further momentum is expected, with +2% growth in 2015 and +3.5% in 2016 (or +4% if sanctions are lifted). However, growth will remain below the pre-sanction annual average of +5%.
- Lifting international sanctions will have a marked impact on trade, with exports and imports both potentially increasing by +20% in 2016 and imports increasing by a further +13% in 2017. There will be opportunities for exporters on Iranian metal, machinery and equipment, automotives and food markets. Initially, European exporters will benefit the most, although current market leaders (the UAE and China) will also make gains.
- For local industries, sanctions relief will result in marked changes in the energy, automotives, construction and retail sectors, with increasing market dynamism but also tougher global competition.
- The post-sanctions period will be challenging. Substantial investment in infrastructure and industry is required at a time when foreign exchange and credit risks will increase and social and political expectations require management. Increasing annual GDP growth to >5% for a protracted period will require structural changes.

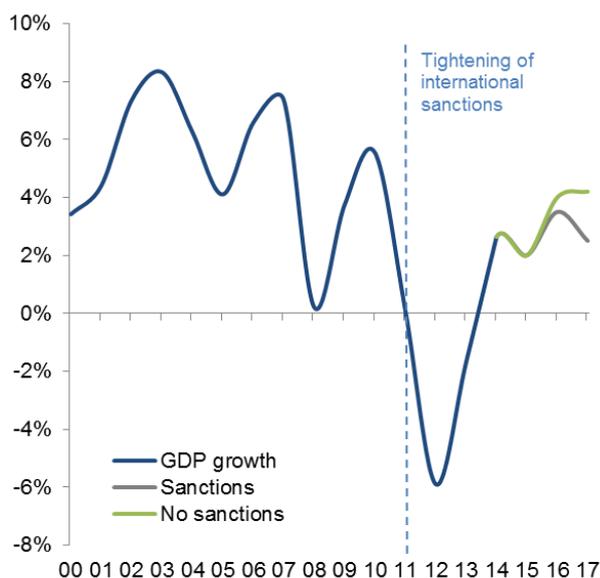
If sanctions are lifted

If the agreement reached on July 14 between Iran and the P5+1 is fully ratified, some sanctions imposed on Iran by the U.S., the European Union and the UN will be removed in 2016. In return, Iran will decelerate its nuclear programme.

Just as the tightening of sanctions in 2011 led to a 2-year recession, the easing of sanctions will have a positive impact on the Iranian economy as it will allow a return of the country to the global financial and energy markets. After +2% forecast for GDP growth in 2015, we project real growth could accelerate to +4% in 2016 and +4.2% in 2017 if sanctions are lifted, but only +3.5% in 2016 and +2.5% in 2017 if sanctions continue to operate (Figure 1). Industrial activity will particularly benefit and could accelerate to +5% per year by 2017 (against +2.9% in 2015), while its annual growth will remain below +2% if sanctions are not eased over that whole period.

Under this new environment, exports (especially oil) and imports are likely to soar, both expanding by close to +20% in 2016, before decelerating slightly in 2017 to +11% for exports and +13% for imports. The net impact on external balances will therefore be limited, and Iran will continue to record large surpluses of

Figure 1: Real GDP growth (y/y, %)



Sources: World Bank, Euler Hermes forecasts

above USD30 bn for merchandise trade and the current account surplus will remain equivalent to around +7% of GDP. Iran will therefore have a financial cushion to finance an economic recovery, especially as, following the removal of sanctions, Tehran will be able to access some of its currently frozen assets held overseas, which are estimated at USD50-150 bn. Moreover, the announcement of the framework agreement in April 2015 already led to an increase in global business interest, with some large companies seeking to position themselves to benefit from the new arrangement. Consequently, FDI inflows are likely to accelerate with the lifting of sanctions, reaching USD3.7 bn in 2017 (Fig. 2), benefiting especially the energy sector as Iran has the world's largest natural gas reserves and the fourth largest oil reserves while oilfields and gasfields require significant amounts of investment and technical improvement after years of sanctions.

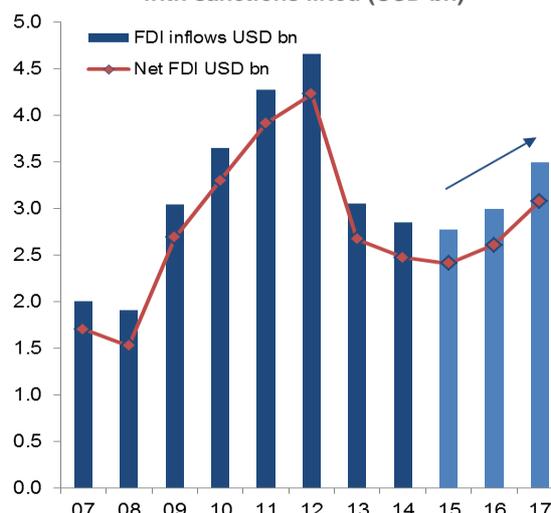
And the winners are: Energy, Autos and Retail

Sector #1: Energy - The lifting of sanctions will automatically unlock Iran's oil sector (25% of GDP), allowing the country to increase its oil production by 600 000 barrels/day in 2016 as a result of destocking (partly from oil supplies already stored on sea-going tankers), and returning to its pre-sanctions production level of 4.1 mn barrels/day as soon as 2017 (Figure 3). Iran's contribution to global oil output will also recover, reaching 5% in 2017. This will generate further downward pressure on oil prices, although international markets have already partially priced in re-entry of Iran into mainstream oil and gas markets. It is likely that Iran will seek to regain its pre-sanctions traditional markets: Japan (19% of Iranian exports of oil in 2006), Italy (7%), Spain (6%) and Taiwan (5%). If that is the case, then countries such as Saudi Arabia and, particularly, Russia will face severe market competition.

Sector #2: Automotive - The removal of sanctions will consolidate Iran as one of the key markets in the region for the automotive sector. Indeed, despite international sanctions, Iran was one of the top 20 passenger car producers worldwide in 2014, with over 900,000 units, and it was the largest market in the region in terms of sales, with more than 1.1 mn new units registered last year, markedly above Turkey and Saudi Arabia (around 600,000). The number of registrations could go back to the pre-sanctions level of 1.4 mn units in 2016 and even reach 1.6 mn in 2017. In addition, local car production will increase by around +15% per year, reaching 1.32 mn units in 2017 (figure 4).

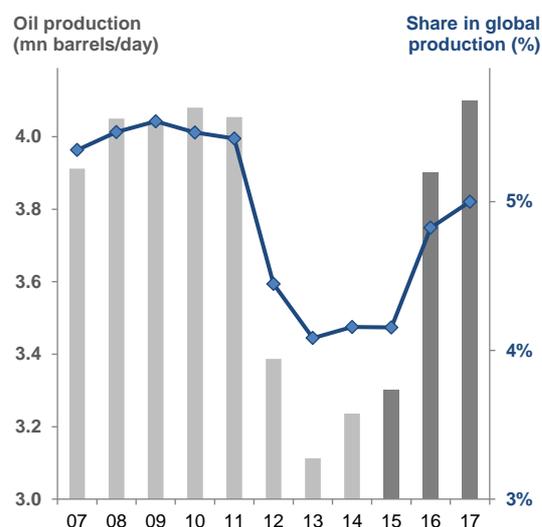
Sector #3: Retail & Consumer Goods - Classified as an upper-middle income country with more than 77mn inhabitants, the domestic market for consumer goods presents potential following the lifting of sanctions. Although the sector remains dominated by small traditional retailers, malls and supermarkets are currently developing, mainly in urban areas. In general, the country presents a significant "new" market for consumer-related products.

Figure 2
Iran: Foreign Direct Investment flows with sanctions lifted (USD bn)



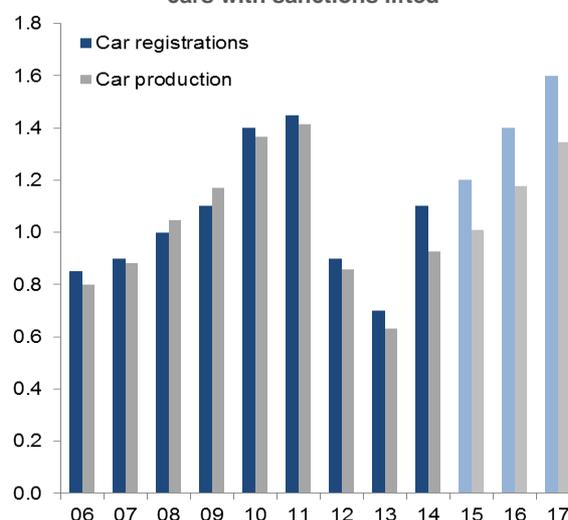
Sources: IHS, Euler Hermes

Figure 3
Iran: Oil Production with sanctions lifted



Sources: IEA, Euler Hermes estimates and projections

Figure 4
Iran: Production and registrations of passenger cars with sanctions lifted



Sources: OICA, Euler Hermes

Business opportunities

Incremental economic activity as sanctions are lifted - in particular, additional private consumption and investment needs - will support import growth, which we estimate could increase by some +USD20 bn over 2015-17. Specifically, we estimate that Iranian purchases of machinery and equipment will rise by more than +USD4 bn from now until 2017, representing more than 20% of total imports. Consumer-oriented markets are particularly promising, with additional imports of manufactured articles estimated at +USD3.1 bn, of road vehicles +USD2.7bn and of electronic devices +USD1.7bn over the period. Additionally, the renewal of the local automotive industry will support imports of iron and steel and of parts and components, which could increase by +USD2.5 bn and +USD1.2 bn, respectively (Figure 5).

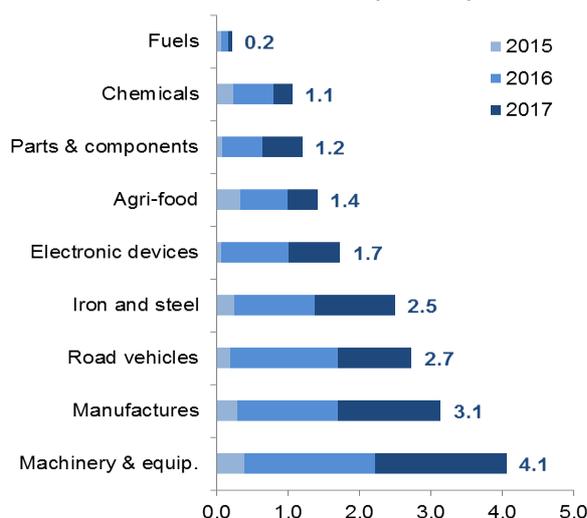
In terms of trade partners, European countries are likely to be the big winners driven by additional exports of machinery and equipment, automotives and agro-food. **Germany** appears to be particularly well positioned and will see its exports to Iran grow by close to +USD2 bn over 2015-17. Export gains of **France** could be +USD1.3 bn, of **Italy** +USD0.9 bn and of the **U.K.** +USD0.6 bn. The **U.S.**, which currently accounts for less than 1% of Iranian imports, will see its exports multiply fivefold, with total export gains slightly above +USD500 mn in 2015-17. The structure of these sales will shift from agro-food and chemicals towards higher value-added goods (machinery, manufactures and electronic devices).

Current key partners focused on higher-value added exports will also be big winners: (i) **the United Arab Emirates**, which currently accounts for almost 30% of Iranian imports, will benefit from Iran's economic boost in the two coming years as it will continue to act as a re-export platform for foreign products to enter the country. It will see its exports increase by USD2.1 bn over 2015-17; (ii) **China** will see its export gains reach USD1.8 bn over the period, mainly driven by iron and steel, machinery, electronic devices and automobiles; and (iii) **South Korean** export gains, which could reach USD1 bn, will be driven by cars and machinery, especially as the country will be a key partner for Iran in developing its construction sector.

Turkey and **Russia** may lose market share to European competitors. After slowing in 2016, their exports to Iran could even decrease in 2017 (Figure 6) notably items in the fuels, chemicals, textiles and agro-food sectors.

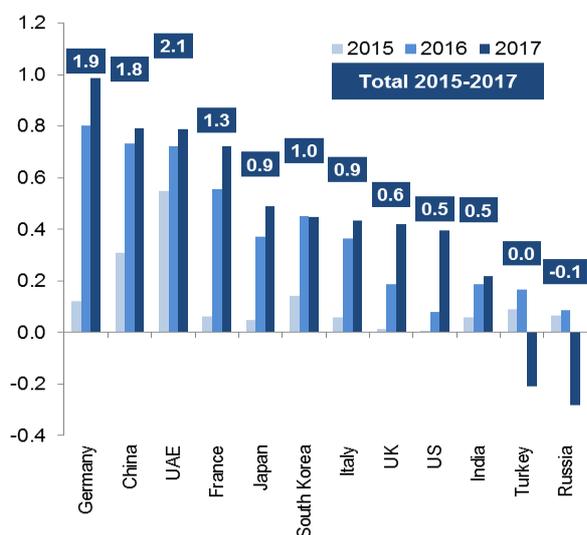
Former and current key-partners (except Turkey and Russia) of Iran will benefit from the economic regeneration of the lifting of sanctions in 2016-17. However, the outlook is more uncertain for the medium-term. While **Japan** and European partners will want to recover lost market share, the U.S. will try to become a new major supplier in key sectors. For their part, **China**, the **UAE** and **South Korea** will fight to keep market share they acquired since 2006 (Figure 7). It is likely to be competitive in all markets.

Figure 5
Iran: Additional imports by sector with sanctions lifted (USD bn)



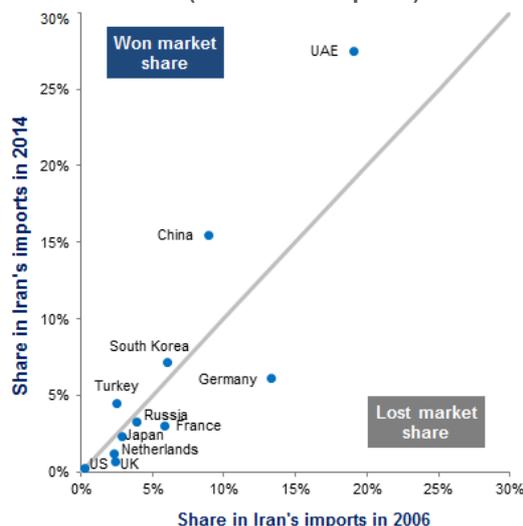
Sources: UNCTAD, Euler Hermes

Figure 6
Iran: Additional imports by origin with sanctions lifted (USD bn)



Sources: UNCTAD, Euler Hermes

Figure 7
Market shares in Iran's market (% of Iran's imports)



Sources: UNCTAD, Euler Hermes

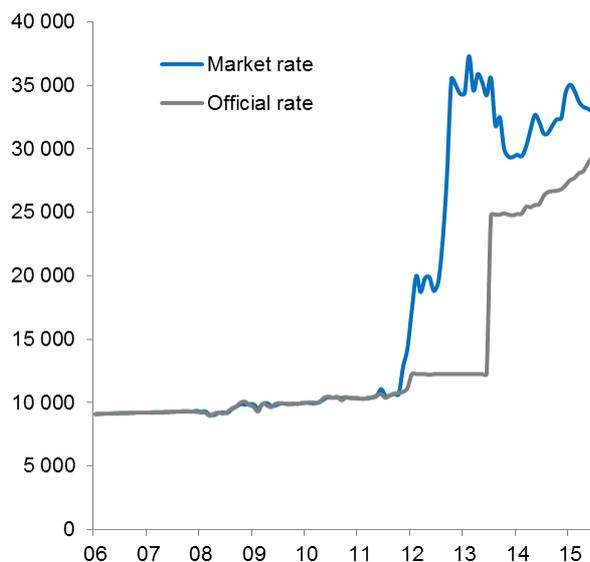
The country's significant potential will be difficult to achieve in the short term

Risk #1: Currency and financing. The effectiveness of the financial system deteriorated under international sanctions. Non-performing loans are around 13% of total loans (the exact figure is probably even higher) and the banking system is largely state-operated. Moreover, major international banks will be wary of dealing with Iran until there is clarity in relation to sanctions; since 2009 banks have been fined around USD14 bn after rulings that they evaded sanctions. Until Iran has free access to global payment systems corporates will find it problematic to conduct business with the country. International traders and investors will want to see reduced exchange rate volatility and rationalization of the current system of official and free market rates for the rial (IRR). Currently, the Central Bank's reference rate is around USD1:IRR29,000 and the free-market rate USD1:IRR33,000. Currency risks stem from a high inflation rate, low interest rates in relation to trade partners and competitors and continuing political and diplomatic uncertainties. However, still large FX reserves provide some support and EH expects the rial will end 2015 at around USD33,700 and end 2016 at USD34,750.

Risk #2: Political and geo-political pressures. Domestic expectations are now high and will be a challenge for the Iranian government to meet, even partially, in the short term. Moreover, elections in February 2016 (Majlis al-Shoura – parliamentary - and Assembly of Experts) and June 2017 (presidential) provide scope for slowing in policy implementation or even abrupt reversals. Much also depends on the progress of sanctions relief in the U.S. and responses by regional actors, including Israel and Saudi Arabia. Ongoing conflicts in Iraq, Syria and Yemen also pose contagion risks.

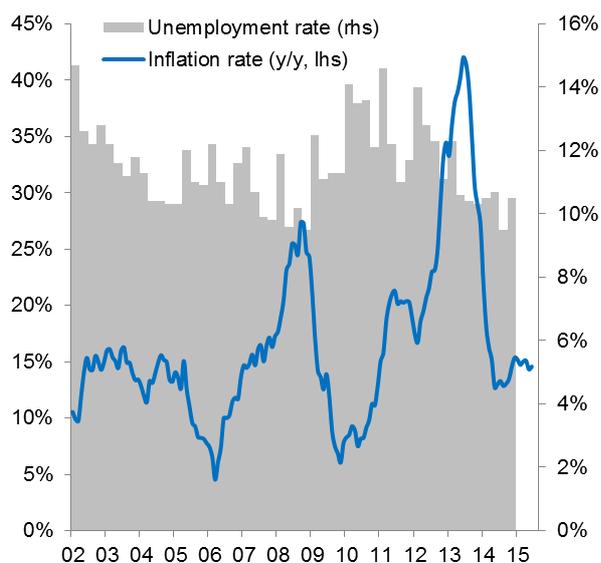
Risk #3: Structural reforms. In the World Bank's Doing Business survey 2015, Iran is ranked 130 out of 189 countries assessed for the overall ease of doing business in an economy. Strikingly, Iran appears to be lagging behind other Middle East countries. Therefore business regulations and protection require changes to inject more confidence. Additionally, unemployment remains high (around 11%), mainly among young people, and investment needs to be attracted to labour- and not just capital-intensive sectors. Without domestic structural reforms to boost investor and consumer confidence, business and human capital flight may increase as Iran opens up.

Figure 8
IRR/USD



Sources: IHS, Euler Hermes

Figure 9
Iran: Inflation and unemployment rates (%)



Sources: IHS, Euler Hermes

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