



MIDDLE EAST INSIGHTS

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IRAN – THE PATH AHEAD

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Iran is the last large, untapped emerging market in the world that is widely expected to flourish in the coming years. Iran's gross domestic product (GDP) is circa US\$415 billion and its economy was ranked 18th worldwide in 2014. Before the nuclear sanctions, Iran was in an even better position with GDP per capita at US\$17.5k in 2011. According to Goldman Sachs, Iran is a country with a high probability of becoming one of the world's largest economies, and could be the world's sixteenth largest economy in GDP (nominal) terms by 2025. Even under sanctions, Iran's economy has been the third largest in the region after Turkey and Saudi Arabia. Iran is also the second largest country in terms of population in the Middle East (after Egypt) with an estimated 78.5 million people in 2014.

The World Bank classified Iran as an 'upper middle-income' country with about 65 percent of the population under 35 years old, and literacy among 15- to 24-year-olds at 98 percent. Total adult literacy is 85 percent. About half of all Iranian households reportedly have internet access.

Iran's economy is characterized by a large hydrocarbon sector, small-scale agriculture and services sectors, and a noticeable state presence in manufacturing and financial services. Iran ranks first in the world in natural gas reserves and fourth in proven crude oil reserves. Economic activity and government revenues still depend to a large extent on oil revenues and therefore remain volatile.

This Insight will give a framework to understand the opportunities and challenges Iran is facing on its new road to economic development in the post-sanctions era.

The paper will start with a macroeconomic overview of the country. Then it will cover two pillars of the economy, namely the energy sector and the banking system.

Sanctions and the Joint Comprehensive Plan of Action (JCPOA)

The landmark event in Iran's recent history was the revolution in 1979, when the Supreme Leader Ayatollah Ruhollah Khomeini replaced the ruling Shah, and the country turned into an Islamic republic.

Although the development of nuclear technology began long before the Iranian Revolution, in the 1950s with American help, it was only relatively recently that the US indicated that Iran would have the technological and industrial capacity to produce nuclear weapons at some point. Hence very severe sanctions were imposed on Iran over the last decade.

In 2006, after Iran refused to suspend its uranium enrichment program, the UN imposed sanctions that initially targeted investments in oil, gas, petrochemicals, and business related to the Iranian Revolutionary Guard Corps. This encompassed banking, insurance transactions (including the Central Bank of Iran), shipping, and web-related services as well. After that, the UN passed further economic and financial sanctions in 2010.

After more than two years of arduous negotiations, the P5+1 and Iran reached in 2015 a provisional agreement on a framework known as the Joint Comprehensive Plan of Action (JCPOA) that, once finalized and implemented, would lift most of the sanctions in exchange for limits on Iran's nuclear programs which were to extend for at least ten years. As a result, UN sanctions were lifted in January 2016, which will open new scenarios and economic opportunities for the country.

Macroeconomic Outlook

The social and economic effects of sanctions have been severe, reducing Iran's access to capital and much-needed technology in many sectors. They also made many international companies reluctant to do business with Iran for fear of losing access to larger western markets. They have also caused a decline in oil production due to reduced access to technologies needed to improve the efficiency of old oil fields.

After two years of recession, the Iranian economy recovered during the 2014 Iranian calendar year, i.e. March 2014-March 2015, thanks to the new administration led by President Rouhani who took office in July 2013, and a partial lifting of sanctions enacted under the JCPOA.

The Iranian economy expanded by 3.0 percent in 2014/15 versus an annual economic contraction of 6.6 percent and 1.9 percent in 2012/13 and 2013/14 respectively. This growth in GDP, combined with a sharp decline in inflation from 35 percent to 16 percent in 2014/15, strengthened Iran's economy and set the national economy on a better sustainable growth path. That did not last long, as the global price of oil collapsed in 2014/2015.

As a resource-abundant country, Iran relies heavily on commodity exports. Thus the economy is very vulnerable to volatility in commodity markets. In fact, circa 80 percent of exports is commodity related, and within that amount, the share of energy related commodities is around 79 percent. The sharp decline in global oil prices has shrunk the liquidity in the financial market, postponed consumption and investment decisions, and slowed down economic activity. Economic growth will most likely be flat in 2015/16, but prospects for 2016/17 are brighter due to the lifting of economic sanctions. Higher oil production, lower costs for trade and financial transactions, and restored access to foreign assets, are expected to increase real GDP by at least around 4.5 percent next year. Much of the acceleration in growth will also depend on the spillovers from increased oil production to the rest of the economy. This can lead to appreciation pressures on the real exchange rate. But continued gradual fiscal consolidation, including sustaining tax revenue mobilization, reform of subsidies, and prudent monetary policy to achieve single-digit inflation by the end of 2016/17, can mitigate these upward pressures.

Energy and Natural Resources

Oil remains the country's most important and strategic export. The location of the country's oil fields is critical since around 70 percent of Iran's oil reserves are located in the south of Iran, with the remainder mostly located offshore in the Persian Gulf. Iran owns the fourth-largest oil reserves in the world and is the world's seventh largest producer. However, the industry is still largely underdeveloped and much of Iran's potential impact on the international energy market from 2016 will depend on its ability to develop its oil and gas sector. About half of the oil output comes from oil fields that started production 50 years ago, thus the latest technology is needed to exploit them. Indeed, Iran hopes to attract significant foreign investment in the long term in order to boost oil production.

With reference to gas, estimates consider the country's reserve base the foremost natural gas reserve in the world. However, years of sanctions have made the business of gas a missed opportunity in the country.

Although Iran holds 17 percent of the world's proven natural gas reserves, it accounts for less than 1 percent of global natural gas traded. Iran exports only minimal amounts of gas, and the majority of its production is for domestic and internal use. In contrast, the small state of Qatar owns the third largest gas reserve worldwide; with a population of 2.5 million people, and accounts for over 12 percent of global gas traded and is the world's largest LNG exporter. Moreover, increasing domestic demand will probably reduce Iran's gas exports. In this context, Iran will probably focus on the export of oil instead of gas. Indeed exporting oil is easier and quicker than gas, which requires significant investments in pipelines and LNG facilities.

Iran is also very rich in natural resources. To illustrate, the country has mining capability for iron ore, metalliferous ores and building raw materials. It produces 2-9 percent of the world's total supply of gypsum, barite, feldspar, nitrogen and sulfur. Through the state-owned Iranian Mines and Mining Industries Development and Renovation Organization (IMIDRO), the government controls assets including those producing aluminum, ammonia, coal, copper, iron, steel, natural gas, petroleum, salt and sulfur. There are also private mining operations. However, although Iran has great mining resources, this sector remains largely underdeveloped, and needs to be improved.

Banking Sector

Following the Islamic Revolution, Iran's banking system was nationalized and made Sharia-compliant. Since 1994 the Central Bank has authorized the establishment of private credit institutions. Following the liberalization plan of the banking sector that resulted in the privatization of existing commercial state-owned banks, the number of private banks has grown year by year. In 1998 the Central Bank authorized foreign banks (many of which had already established representative offices in Tehran) to offer full banking services in Iran's free-trade zones.

In 2009 the Council of Ministers approved new regulations to encourage foreign banks to open branches and allowed them to open customer accounts in the country. However, so far no foreign bank has had a direct presence in the Iran banking industry.

In 2015 around 31 banks, including 24 commercial, five specialized, and two Garz-al-hasanah (savings banks), were operational in Iran. Excluding the specialized banks that are all owned by the government, only three commercial banks are still public and fully controlled by the government.

As of March 2014, according to Reuters, Iran's banking assets totaled US\$523 billion, and made up over a third of the estimated total of Islamic banking assets globally. Although the amount of assets is massive, the balance sheets of the banks are suffering: due to poor risk management, non-performing loans account for 14 percent of total loans, and most Iranian banks have very low capitalization. A boost to liquidity in the banking sector will come from the JCPOA, since it will allow Iranian entities to access US\$29 billion of Iran's money that has been blocked for long time.

Another positive note for the sector is the fact that Iranian banks are now allowed to trade with the rest of the world and use the global banking system SWIFT. But access to SWIFT was not the only obstacle to Iranian banks in restoring relationships with their foreign counterparts.

Although Iran recently has made a good progress towards developing the legal and regulatory framework to promote the country's credit status, there are still some concerns for foreign banks in dealing with Iran. Iran voluntarily handed the Anti-Money Laundering law to the International Monetary Fund and the Guardian Council has approved the bill on

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Combatting Financing of Terrorism on March 2016. Also the central bank has developed a total of 13 instructions to cover all aspects of the fight against money laundering, domestic banking operations are still believed to lag far behind global best practices in this regards.

There are other reasons for foreign banks hesitation in dealing with Iran. Above all it is the fear of fear of retaliation by US authorities. Some experts believe US knowingly has left some ambiguity in the JCPOA to open its hand in interpreting future disputes. But this has not deterred all foreign banks from doing business with Iran, despite that major European and US banks are still cautious and prefer to stay vigilant.

Conclusion

Iran is very rich in natural resources and yet it has a very diversified economy thanks to significant manufacturing and industrial sectors. But it is only the 29th largest economy in the world, and ranks only 93rd in per capita gross domestic product.

Part of the reason is related to inefficiencies and sanctions, but the main problem is the geography: a huge population is located in rugged mountainous territory. Mountain regions have inevitably higher infrastructure costs to connect people and transport goods, hence the development of industry is more difficult and less profitable. The huge amount of natural resources allows the country to reach a good level of output, but the challenges imposed by geography cannot be ignored.

Moreover since the revolution the economy has had to deal with an eight-year war with Iraq (1980-88), widely fluctuating oil prices, international isolation, sanctions, and inaccurate policies in the last years, but the JCPOA clearly represents a historical opportunity for economic development.

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