Flash Comment #98

February 5, 2016

Iran: lifting of sanctions unleash large potential, but large risks need to be priced in

The lifting of sanctions regarding Iranian oil and most other export and import should allow foreign companies to look at the formidable potential for medium-term developments of the country.

Over the short run, economic activity should accelerate despite low oil prices, to above 5%; the country has a strong fiscal resilience and a substantial foreign currency buffer. Inflation remains high and the currency remains overvalued from a competitive perspective, but could be supported by increasing FDI.

Political risks remain huge however, including medium-term uncertainties on sanctions "snap back", regional and international instability, and potentially acute domestic tensions with upcoming elections on February 26. This leads to a large overall country risk premium, above 600 basis points.

Iran is hugely attractive for foreign companies and investors

From a broad geopolitical and strategic perspective, Iran has most if not all the attributes of a regional power: a large geographical presence and population, long and strong history associated with tradition of diplomatic influence, significant military weight and strength, large resources, educated people!

It could be fairly argued that the Islamic revolution and its aftermath have postponed reaching this status and regional influence, by basically putting the country "at odds" with global international developments. Hence the importance of the agreement reached between Iran and the so-called P5+1 group (the US, UK, France, Germany, China and Russia), can be interpreted as the first significant step taken to bring Iran back to what should be its economic, trade and financial importance.

Available figures confirm the country's large potential for economic and trade development: the table below compares a couple of simple data across a range of MENA countries.

Regional comparison: Iran against its peers

Data for 2014	Iran	Egypt	Saudi Arabia	Turkey	Algeria
GDP (bn $)	**416**	286	746	798	213
Population (mn)	**81,2**	88,5	27,8	79,4	39,5
% urban pop.	**73**	43	83	73	70
GDP/cap (PPP $)	**5 353**	3 304	24 252	10 381	5 406
HDI* (0-1)	**0,766**	0,690	0,837	0,761	0,736
Imports (mn $)	**80 368**	73 525	255 383	257 860	71 035
Investment/GDP (%)	**31,0**	14,0	27,8	20,2	47,8
FDI** (mn $)	**2 105**	4 783	8 012	12 146	1 488

* Human Development Index (includes GDP per capita, education and health indicators)
** Foreign Direct Investment

Source: TAC ECONOMICS, IMF, World Bank

Assuming a reasonable acceleration in economic growth associated with increasing trade content suggests that the country's total imports could grow from its current levels around USD 85-90 bn to USD 175 bn over the next five years. Similarly, a "reasonable catch-up" in FDI coupled with Iran's attractiveness for oil and gas investments in the current low price environment (production costs remain below current price levels) indicates that annual inflows could easily reach USD 10 bn over the short-term.

Do not expect too much from post-sanction higher oil revenues… but Iran can cope with it

A preliminary point is the simple observation that the lifting of sanctions on oil exports will not lead to a major increase in Iranian sales. Taking into account the depletion rate of existing fields and different assumptions on new investment, a "best case" implies that production levels already seen in the mid-2000s (i.e. at or above 4 mn b/d) will not be reached before 2020. Adding sharply increasing domestic consumption if the economy accelerates, the exportable surplus is unlikely to be massive.

In parallel, Iran's "economic" ability to withstand a "longer-than-expected" period of low oil prices is rather strong: partly because of past sanctions, Iran's fiscal accounts are far less reliant on oil income than most energy producers (the IMF estimates that 70% of total spending is "covered" by tax income and non-oil revenues); average oil production costs are among the lowest in the world; and foreign currency reserves are large, even before the unfreezing of assets held abroad as a post-sanction relief (USD 128 bn, i.e. around 18 months of imports); total government debt as well as external debt are low (respectively 15% and 2.5% of GDP in 2015).

Economic and financial risks are related to the currency, inflation and the operating environment

The traditional "polygon of risks" used in our RiskMonitor tool is useful to assess the "weak" points in Iran's current situation, but also the potential implications of the lifting of sanctions.

Three things stand out:

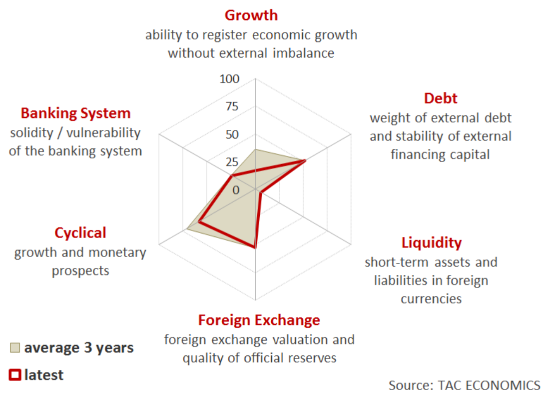
- Two Fundamental Balances are very strong (Growth and Liquidity), suggesting the ability to achieve a "rapid and balanced" growth path with an equally strong capacity to smooth external shocks and potential financial volatility.

- A third Fundamental Balance is good… but for "wrong reasons": the favorable score on the Banking System Balance expresses that the very limited level of credit intermediation and financial sanctions have reduced the Iranian's banking sector to a very constrained and limited role. This implies indeed the absence of systemic banking risks, but simultaneously indicates problems in normal banking activities.

- The three other Fundamental Balances are poorer: the Debt balance, reflects years of financial sanctions when FDI almost dried up and access to debt or capital markets for Iranian borrowers was shut. The lifting of sanctions should lead to higher FDI and a rapid improvement in the Balance. Regarding the Cyclical Balance, we should also expect a reversal in the *real economic pressure index* as a direct result of the lifting of sanctions; we therefore have the two more worrying aspects, inflationary pressures on one side and currency valuation on the other side.

Economic & Financial Risk Rating - Iran 39,8-B

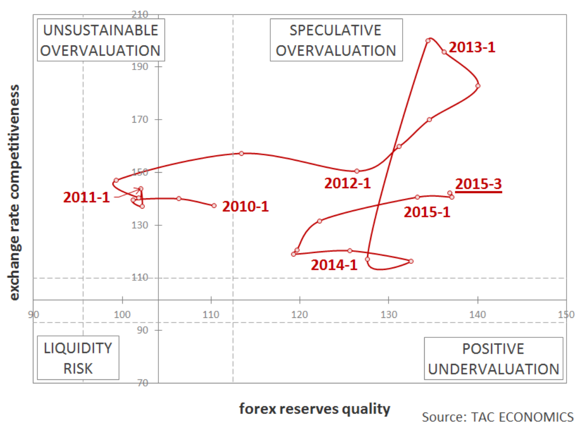
from 0 (lowest risk) to 100 (highest risk)



Inflation has been over 10% since the beginning of the decade, with peaks above 40% year-on-year in 2013. It has remained strong in 2014 and 2015 despite restrictive policies, and partly related to adjustments in administered prices and subsidies. Our tools suggest that the combination of rapidly growing demand, rigidities in supply chains and price-adjustment inertia could stop the recent improvement towards 10%.

Related to the high level of inflation is the issue of the currency competitiveness. Despite the sharp depreciation engineered in 2013, our index still shows a substantial competitive handicap, with our index of exchange rate competitiveness about 20% above the higher range of "neutral values". The combination of performance has indeed switched on a WatchList Indication of a possible currency shock (i.e. at least 20% real depreciation over a quarter) in 2016.

Foreign Exchange Balance



The "regime change" implied by the lifting of sanctions may however prove our WatchList wrong: indeed, with a balanced current account, expectations of large FDI and asset repatriation, and inflation worries could lead to a stabilization or even an appreciation of the Iranian Rial. This would be negative in the long run and create "Dutch Disease" symptoms, and certainly should be looked at in details if looking at Iran as an export platform.

Politics still a huge Damocles Sword!

Our positive economic assessment is however still hugely balanced by the acute political uncertainties:

- The international agreement itself remains loaded with uncertainties, notably the "snap back" clause, which enables to re-install sanctions "immediately" if Iran is found or thought to be reneging on its nuclear commitments, over the next 8 years; adding the "outreach" of US judiciary in punishing foreign companies over their dealings with Iran, it creates a massive legal risk for long-term project. In parallel, a number of sanctions remain in place, related to military / terrorism issues.

- Critical domestic elections take place in Iran on February 26, for the National Assembly (Majlis) and the Assembly of Experts (a smaller group of elected religious leaders who have the "ultimate say" on the selection and potentially removal of the Supreme Leader Khameini). Tensions are reaching a climax as the more conservative segments of Iranian clergy and political leaders have vetted a large number of "reformist" candidates, with a clear possibility of more open political tensions if elections are rigged or its results hugely contested.

- Last but obviously not least, the regional and international context and Iran's policies remain hugely uncertain and prone to unexpected accidents. The conflict in Syria and Russia's intervention, the escalation of tensions with Saudi Arabia, the poor relations with Turkey and Pakistan, are all pointing to very substantial risks.

The bottom line of our analysis is that the attractiveness and medium-term development potential of the country suggest a growing interest and a need to look at opportunities. Currency competitiveness and inflation, funding and banking requirements are the most pressing economic challenges, associated with a poor business environment and huge political risks. This leads to a global country risk premium above 600 basis points, i.e. a 6% extra-annual return to correctly compensate for the aggregate country risk.