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Research Report

Iran: Economic revolution or recession?

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Matthias Diermeier

Iran

Economic revolution or recession?

International traders' and investors' expectations were raised after Iran had pledged to implement the landmark nuclear deal negotiated with the US, UK, France, Russia and Germany. While the Islamic Republic constitutes a trading hub with great economic potential, large amounts of goods or investment sums have yet to cross its borders. Instead, US-imposed sanctions that should have been lifted months ago de facto remain in place.

Diplomatic relationships with Western nations have improved significantly after the Islamic Republic of Iran committed to complying with the Joint Comprehensive Plan of Action that was agreed upon in Switzerland in 2015 (JCPOA, E3/EU+3 and the Islamic Republic of Iran, 2015). President Hassan Rohani was received by the governments of France and Italy, Tehran has welcomed delegations from most major economies. Politicians as well as CEOs were equally excited to revive trade relations with Iran.

After decades of political and economic isolation, Iran has re-entered the world stage. Its appearance has raised expectations, both internationally and on a domestic level. The Iranian government is expect-

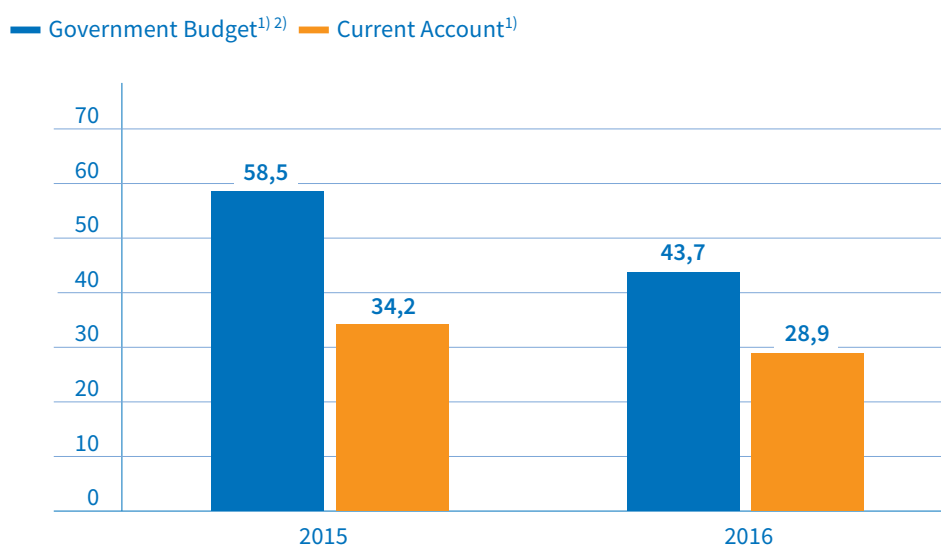
ing an annual investment inflow of US\$30–US\$40 billion in order to modernise its economy. President Rohani's strategy was widely backed by the electorate. Now, he will have to deliver an economic upswing: for enabling citizens applauding the nuclear deal to reap the rewards of the new openings and to reach his ambitious 8% annual GDP growth target.

Coming from a stagnation in 2015, the Iranian economy longs for a stimulus from abroad. While Western companies are eager to access the market, investments have not met the expectations so far.

At a first glance, Iran might not appear to be a first-class choice for long run investments. Human rights violations and the execution of the death penalty occur daily, inflation has peaked at over 40% only three years ago and the Republic struggles with Saudi Arabia's hegemonic ambitions. Erratic top-down decision making structures create uncertainty about the deal's implementation. Furthermore, the US presidential elections and a looming president Trump cast a cloud over the country.

Still, several factors could attract international in-

Break even crude oil price



1) given the current exchange rate

2) given crude oil revenues are entirely used to finance the government deficit

Source: Bloomberg; Trading Economics; Rystad Energy; Cologne Institute for Economic Research

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vestment flows: The Iranian government has created special economic zones in order to pave the way for foreign investors. The zones try to incentivise investments by providing a 20 year tax holiday, amongst others (Invest In Iran, 2016). Talks to join the WTO started in 2005 and are now relaunched – by GDP, Iran represents the biggest non-WTO member. Negotiations about strategic arrangements between the EU and Iran on energy have been kicked-off in April this year. Also, a joint statement for the relaunch of human rights talks has been published (European Union External Actions, 2016).

What is more, in comparison with countries from the Arabian Peninsula, the Iranian economy is relatively diversified, having been forced into a large period of import substitution. With oil prices returning to normal heights, this could mean that the economy is less vulnerable to the Dutch disease – describing the problem of a stark dependency on one specific commodity – than other competitors. On the other hand, the cost of oil production of one barrel lies at only US\$12.6 and is among the lowest in the world – only Kuwait and Saudi Arabia produce at less than US\$10 a barrel. A deal that Iran struck with India has kicked

in already and is – according to Iran’s First Vice-President Eshaq Jahangiri – expected to increase oil exports to two million barrels a day. The deal will inflate the current account surplus more than tenfold and reduce the government budget deficit by two thirds. With oil exports increased to 2 million barrels per day the Iranian current account is expected to break even at an oil price of US\$29 this year, the government budget if the price reached US\$44 – ceteris paribus (see figure). Rosy and particularly solvent expectations, given that a barrel of Brent crude oil currently sells around US\$50.

Western companies interested in investing in Iran face three major challenges:

First, public credit insurance companies are waiting for outstanding debts to be paid. The German governmental credit insurer Euler Hermes, for example, just concluded negotiations with Iranians officials over an outstanding payment of around €500 million. With the dispute being settled, Euler Hermes will soon back German companies (BMW, 2016).

Second, having access to credit insurance will not make it easier for a company to find a Western financial institution to process a payment with an Iranian counterpart or fund an investment in the Islamic Republic: Western banks are reluctant to provide financial services for companies willing to interact with Iranian businesses. Although the global transaction network SWIFT has reconnected Iranian banks to the world's financial infrastructure, only very few small Western financial institutions are actually making use of this possibility.

The Western banks' reluctance with regards to conducting business with Iran is caused by the third and most important challenge: Whereas the EU has lifted its sanctions – with the minor exceptions of the arms and ballistic missile's embargo, restrictions on sensitive goods, and human rights abuses and support for terrorism – the US continues to directly and indirectly condemn trade with the Iran.

Primary sanctions directed against US citizens are still in place, as are – under certain conditions – several secondary sanctions, directed against non-US persons. Basically, all transactions are sanctioned that are related to Iran and carried out in US dollars, via US territory or involving an US citizen, a company or a person listed on the Office of Foreign Assets Control's (OFAC) Specially Designated Nationals list (SDN), the Iranian Government or the Islamic Revolutionary Guard Corps (US Department of the Treasury, 2016a; 2016b). The sanctions are directed against all subjects carrying out the deal and are often pursued – for example if the charge is terrorist financing – by the US Justice Department and not by the OFAC. The draconic sentence of nearly US\$9 billion against BNP Paribas – partly for violating US sanctions in Iran – explains why major banks are not even willing to carry out standard financial services. In fact, the entanglement between the SDN-listed persons in the Western companies' business partner is so difficult to unravel that banks seem to back away from any deal. Some small financial institutions having had economic ties with Iranian companies throughout the last years – carrying out financial

services for non-sanctioned goods – do not rely on costly screenings as they have known their clients in person for a long time. These banks do provide financial services to their customers just now.

To knock down the screening cost investment barrier, investors increasingly demand a so-called EU-published white list of projects to be financed without fearing US sanctions. Unfortunately, insiders doubt the effectiveness of such list, as no authority could guarantee exception from punishment by the US Justice Department. Iran's economy remains the US authorities' cue ball. OFAC can issue specific licences for US citizens to engage with Iranian business partners – including commercial passenger aircraft, which is highly relevant for the recent Airbus and Boeing deals. Even so, having obtained an OFAC license does not guarantee exemption from US legal persecution.

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