

Iran's economy muddling through scorched earth

Atradius Economic Research – September 2019

Summary

- The 2015 nuclear deal didn't give Iran the expected international trade and investment opportunities due to the unilateral re-imposition of sanctions by the US last year.
- Iran's economy has returned to resistance mode and is determined to outlive the Trump administration. High inflation and subdued long-term growth prospects are the price to pay.
- Payment capacity is not yet at stake, but political risks are high. EU sanctions and/or an Iranian exit from the nuclear deal are possible next steps, while large-scale social unrest and military conflict are tail risks.

The period of reprieve for Iran after the nuclear deal with the P5+1 (the UN Security Council's five permanent members and Germany) that was signed end-2015 proved to be short-lived. The US started to unilaterally re-impose nuclear sanctions in May 2018 and has steadily increased pressure ever since to contain Iran's military influence in the Middle East region. The use of so-called 'scorched earth' tactics as a means of US economic warfare, goes much beyond the financial sanctions and the oil export embargo that it originally had in place. Washington is now also targeting Iran's metal and petrochemical exports. It designated Iran's Revolutionary Guard, which is deeply entrenched in Iran's economic and political life, as a terrorist organisation. Moreover, the supreme leader Ayatollah Ali Khamenei and the minister of foreign affairs Mohammad Javad Zarif have been blacklisted, closing off all official diplomatic channels. The idea is to completely isolate Iran from the rest of the world via the extraterritorial

effect of the sanctions, playing on the fear of non-US companies and financial institutions to fall foul to US fines.

Obviously the (geo)political risks for Iran are huge, which makes it a difficult market for exporters. This research note focuses on Iran's economic resilience, which is important for its external payment capacity, but also potentially reflects on the social stability of the country. This isn't Iran's first rodeo and the return to a 'resistance economy' will make Iran a tough nut to crack. But the Iranian population will need to muddle through another period of low growth and high inflation, while being deprived of global technological advancement.

Growing geopolitical tensions

Iran has long refrained from retaliatory measures, but is hard-pressed by the US to resist. On top of that, EU support in keeping the deal alive is slow to

come forth. A special purpose vehicle called Instex to facilitate mutual trade and bypass US sanctions took the EU more than a year to set up, and is perceived as a paper tiger. It covers mainly humanitarian goods, which is not what Iran bargained for.

In exchange for containing its nuclear activity the lifting of sanctions should have resulted in Iran's normalisation of key oil exports and its re-integration into the world economy. Consequently, Iran has started to less strictly adhere to some of its own obligations under the nuclear deal, and has warned it would further increase nuclear activity if not more is done by the remaining signatories to salvage the deal. Tehran has also made clear it is not willing to negotiate with Washington under threat. A number of incidents involving oil tanker harassments and shot down drones have toughened the stance on both sides, and increased the risk that policy miscalculation could lead to a military escalation.

Return to 'resistance economy'

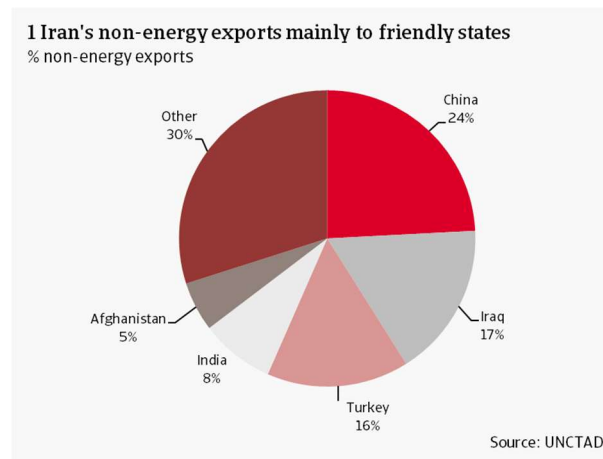
The term 'resistance economy' was used by the Iranian government to describe the country's efforts to withstand international sanctions between 2012 and 2015. It entailed increasing reliance on domestic production and switching to barter trade as an outlet for curtailed oil exports. By lack of international support, Iran has now been forced to fall back on this tried policy.

To cope with declining dollar inflows, Iran has implemented a ban on more than 1,300 import products. Although less deliberate, the sharp depreciation of the rial on the free market will further help to reduce the import bill. By making non-subsidised imports much more expensive compared to local products it will also reduce pressure on international reserves and stimulate domestic production. As a result, the current account will retain a slight surplus, even after the drop in Iran's oil export from more than 2.5 million barrels per day (bpd) in April 2018 to not more than an estimated 400,000 bpd in July 2019. This level is well below the 1.1 million bpd trough in the previous sanction period.

Shrinking oil revenues are more problematic for the budget deficit. Cutting the heavy subsidies and social transfers burden would surely incense the population. However, by focusing on the least socially sensitive fiscal consolidation measures, such as cutting capital expenditures and lowering public sector wages in real terms (while raising nominal ones) the Iranian government is still able to limit the widening of the budget deficit to 5.5% of GDP from just below 2% in 2015-2019 (EIU forecast). Such a deficit is manageable. For

financing, the Iranian government could temporarily fall back on the old survival trick of monetary financing (i.e. printing of money) directly by the central bank or indirectly via the domestic banking sector.

Besides barter deals to circumvent USD restrictions Iran has always found ways to remain below the radar for example via turning off tracking systems on oil tankers. The US is therefore unlikely to succeed in reducing Iran's exports to zero. Moreover, the share of non-oil export amounts to about 35%, comprising of petrochemicals, plastics, metals and vegetables & fruits. Those export goods seem somewhat more sanction proof, since the main destinations are countries with a critical stance vis-à-vis the US-Iran policy (such as Turkey, China, India and Iraq, see figure 1).

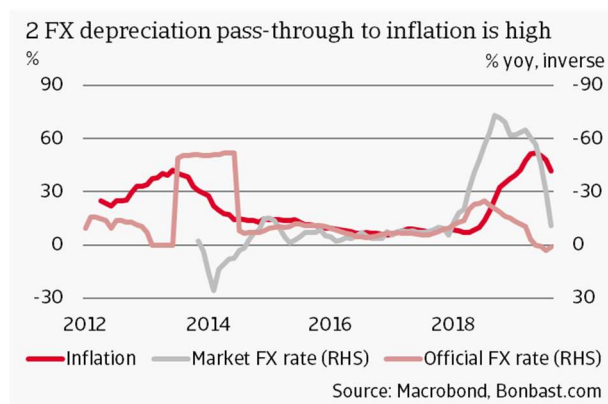


Together with Iran's cost competitiveness improvement due to depreciation of the currency, this could somewhat cushion the expected blow to total exports. However, the chilling effect of the US sanctions should not be underestimated. Although a breakdown of Iran's exports of goods is not available for 2019, in dollar terms non-oil export growth did already slow down significantly to 4% in 2018, from 17.5% in 2017.

Higher inflation is a price to pay

Iran's 'resistance economy' is by no means a foolproof way to deal with the impact of sanctions. The annual inflation rate has already soared above 50%, surpassing the peak of 45% during the previous sanction period in 2013. There are various reasons behind this inflationary pressure. First, Iran has once again failed to unify its parallel currency system of official (fixed) and free market (floating) exchange rates, while the exchange rate depreciation of 70% on the free market was much sharper than after the similarly failed unification attempt in 2013 (see figure 2). Second, the pass-through of the exchange rate depreciation to consumer prices is much higher than would be

expected from Iran's limited import share of 25% of GDP. Foreign exporters that still dare to deal with Iran wield substantial pricing power over the country, because they do not have to fear losing market share, given Iran's isolated situation.



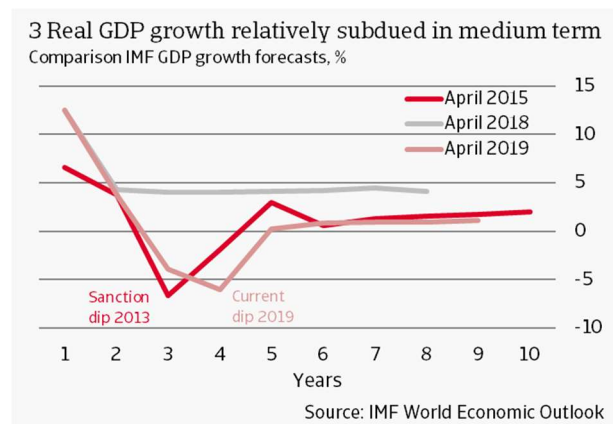
Third, higher inflation is not only the result of the currency depreciation driving up import prices. Import volumes are also declining due to waning appetite from exporters to deal with Iran and the self-imposed import ban, which are contributing to product shortages as the domestic industry cannot easily substitute the import loss. This situation is less favourable than in 2013, when the devaluation was followed by an interim period of sanction relief and rising imports. If the authorities revert to monetary financing of the budget deficit, this would add to the inflationary and exchange rate pressures.

Inflation is highest for the 'luxury' items on the import ban list. The consumer prices for seafood & fish and fruit & nut products that are on this list soared 90% and 110% y-o-y respectively end of 2018, which is higher than the depreciation of the market exchange rate of 70%. It is even more problematic that essential goods are becoming less affordable, despite the fact that importers can obtain cheap dollars against the fixed official exchange rate to purchase them. For instance, the consumer price of bread & cereals increased 30%, which is much more than the 10% devaluation of the official exchange rate would justify. Anecdotal information suggests that part of this government subsidy disappears in the pockets of middlemen.

Damage to economic growth is long-term

Import limitations and sanction fears among trade partners are also a huge setback to Iran's growth potential. Iran's economy is estimated to have contracted 4.9% in 2018, which will likely be followed by a 6.5% decline in 2019 (EIU forecast). Moreover, the IMF only expects a recovery of about 1% in the medium term after the economy has adjusted to the sanction impact. This is way below Iran's 4% potential growth rate right before the US

sanction snapback. Iran's medium term growth outlook is now even less rosy than at the time of the previous sanction period, when the IMF was predicting economic growth to converge back to 2% (see figure 3).



Labour supply is not the main bottleneck, although brain drain is an issue. The Iranian population is relatively young (40% is less than 25 years old) and highly educated. Urgently needed to raise productivity and unlock Iran's huge growth potential is technology transfer from abroad and large investments in the oil sector as well as in non-oil sectors. The oil industry has been facing capacity constraints after years of underinvestment. The more the existing old capital stock becomes obsolete, the larger the drag on growth. The import of capital goods has already receded by 8% in 2018. The few foreign direct investment pledges that were made by multinational companies like Total and Siemens have not materialised. Iran's weak banking sector makes domestic financing of investment projects difficult. Moreover, public investment projects will be the first to suffer from fiscal cutbacks. An additional risk here is that Iran fails to implement the remaining laws against money laundering and terrorism financing that are required by the Financial Action Task Force (FATF) – a global watchdog – before the October deadline. This could put Iran back on the blacklist, making due diligence for the limited number of banks that are still servicing transactions with Iran even more cumbersome to conduct. It could also jeopardise the functioning of Instex, as the Europeans have clearly indicated they would like Iran to conform to international regulations.

Although the increase in the share of Iran's capital goods imports coming from EU companies to 28% in 2018 (from 23% in 2017) suggests Europe is doing more than others to keep the nuclear deal alive, European exporters are bound to lose a promising market (see box).

Box: European exporters of capital goods are losing a promising market

For imports of Western technology Iran is highly dependent on the EU, given that capital goods imports from the US are nearly impossible because of the sanctions. On the other hand, the share of exports to Iran in total EU exports is very small (0.2%). Nevertheless, for specific European companies that were just warming up to the market the current crisis is an unwelcome development. While about a third of their trade involves medicines, cereals and other commodities (which are partly essential goods), the share of capital goods in EU exports to Iran has risen from 33% in 2013 to about 43% since 2016. A complete reversal of trade with Iran could cost European capital goods exporters USD 3 billion revenue annually or even more, given that the US sanction regime is tighter than during the previous sanction period. The Instex facility could help to limit this loss if it expands its scope to include capital goods. From Iran's perspective it will also be good if the facility would be opened up for use by third countries including China. China – Iran's biggest capital goods supplier – already substantially scaled down its delivery of capital goods to Iran in 2018.

A risky business

Iran remains a difficult market for exporters. The good news is that Iran's external payment capacity (and willingness to pay) is not at immediate risk. Iran's foreign liabilities are limited after years of isolation. Despite some capital flight, Iran has enough international reserves left to defend the currency. Reserves are estimated by the EIU to cover 17 months of import and are supported by the persistent current account surplus. While social tensions are growing under the current economic hardship, large-scale violent social unrest has not yet occurred. Up till now reformists and hardliners (backed up by strong security forces) are united in preventing politically destabilising movements in the face of the current external threat. Inflation remains elevated, but will gradually come down from its current peak level now that the market

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exchange rate has been more or less under control, and import substitution will gradually reduce the scarcity of goods.

In this light, there are still exporters that do business with Iran. These are often companies with little exposure to the US market and are subsequently less at risk of US extraterritorial sanctions. However, there is still the general risk that payments may not get through. The already limited payment channels to Iran could be further reduced if the few remaining correspondent banks get cold feet and/ or Iran is being put on the FATF blacklist. Additionally it cannot be ruled out that the EU will re-impose sanctions in response to Iran's violations of the nuclear deal. Although not our baseline scenario, the risk of a military conflict with the US is looming, which could disrupt shipping routes and could have devastating spill-over effects on the region.

Some sort of reconciliation with the US would be required for the Iranian economy to be able to rise from the ashes of the US scorched earth tactics. Iran's hope is that with a new US President negotiations could be revived on more equal terms. US elections will be held in 2020. If a breakthrough does not happen before the next Iranian presidential elections of 2021, prospects for a quick solution become dim. Hardliners may then come into power in Iran after years of hardship and disappointment under President Rouhani's reformists, which could mean an Iranian exit from the nuclear deal, cutting Iran's last ties to the global economy.

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