

Iran: Down, but not out

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- There is little doubt that new US-led sanctions are taking a toll on Iran: the economy is now forecast by the IMF to contract by 9.5% this year, surpassing what was already a dire projection of a 6% fall in GDP.
- It is not all gloom, however. The “parallel” market is picking up some of the slack, as non-oil driven sectors such as manufacturing, petrochemicals, food and textiles as well as trade with China, Turkey, Syria and Iraq remain stable.
- Protests in neighbouring Iraq have challenged Iran’s influence in that country. Initially, demonstrations were over local grievances, but this has morphed into a protest against Iranian intervention.

Sanctions pressure oil

Iran is playing down its economic troubles despite its high unemployment rate, soaring inflation and unpaid wages. The IMF and World Bank, however, are starkly pessimistic about Iran’s immediate future, given the downside risks of fractious relations with the US, regional geopolitical tensions and a vulnerability to oil price swings.

- Sanctions have particularly reduced trade with Europe, mostly exports which have been close to 90% energy-related in the past.
 - Fear of US penalties mean there are now no open European imports of Iranian energy-related goods despite the establishment of a European system designed to allow some trade through indirect means.
 - The fear of secondary sanctions is also posing humanitarian challenges as aid organisations are unable to access donations.
 - Overall Iranian oil exports have dropped significantly, from a peak of 2.8 Mb/d in 2018 to an estimated 500 Kb/d now. Sanctions have halted trade with regular buyers, such as India and South Korea. China, nonetheless, remains a buyer.
 - As a result, production has decreased from 3.5 Mb/d in 2018 to 2.1 Mb/d YTD. The Ministry of Oil expects oil production to decline even further.
 - At this rate, the IMF projects that Iran would need oil priced at USD 195 pb to balance its budget in 2020. This month, Brent averaged USD 62 pb.
 - We see Iran trying to focus their exports on non-oil products such as raw materials, but this will not make up all the lost oil revenue.
- On the currency front, the rial has been on a rollercoaster, plunging then recovering over the past year.

Table 1 - Iran Macroeconomic Indicators¹

	2015/16	2016/17	2017/18	2018/19	2019/20f
Real GDP Growth (%)	-1.6	12.5	3.7	-3.9	-9.5
Crude Oil Production (M Bpd)	2.9	3.6	3.8	3.4	2.5
CPI Inflation (%)	11.9	9.1	9.6	28.1	34.1
Fiscal Balance (% of GDP)	-1.8	-2.3	-1.4	-3.2	-4.2
C/A Balance (% of GDP)	0.3	4.0	3.8	4.3	-0.4
Total Gov't. Gross Debt (% of GDP)	38.4	47.5	39.5	33.2	30.0
Total Gross Extrn'l Debt (% of GDP)	5.6	2.1	2.0	2.0	2.0
Gross Official Reserves (Mos. of Imports)	19.4	15.5	15.2	16.8	16.2
Nominal GDP (USD B)	375.4	404.4	430.7	452.3	484.7
Population (Millions)	79.3	80.2	81.1	82.0	83.2

- It is currently trading on the black market at around 115,000 to the USD vs 154,000 in May of this year and 62,000 in May of 2018.
- Iranian Central Bank Governor Abdolnaser Hemmati has said he has been able to strengthen the rial by 40% since the onset of the new US sanctions in 2018 that led to the currency's free fall.
- The Central Bank of Iran (CBI) wants to devalue the rial and rename it the toman (currently the term for 10 rials). The bill has been sent to Parliament, but we do not expect it to pass anytime soon.
 - At present, there is both an official exchange rate set by the CBI and a market rate that is used in regulated exchange houses.
 - The CBI has integrated the black-market rates into the foreign exchange market through NIMA -- the bank’s online currency system -- allowing exporters to sell foreign currency for rials under the conditions of the third party “Hawala” payment system.
 - For years, the CBI has been operating an official rate of IR 42,000 to the USD for imports of goods.
 - In 2015, when the Joint Comprehensive Plan of Action (the nuclear deal) was agreed, the rial traded at 32,000 to the USD.
 - The CBI proposed a similar move to the toman in 2017 but this was not approved by the government for fear of raising inflationary pressures.
 - With parliamentary elections scheduled for March 2020, it is unlikely for a decision to be made before the new Parliament takes over.

Iran’s ability to withstand some sanction pressures can be demonstrated by the IMF projection of zero growth for 2020 compared with this year’s big contraction. Several factors could support resilience.²

¹ Arabia Monitor; IMF.

² The World Bank also projects 0.5% growth for 2020.

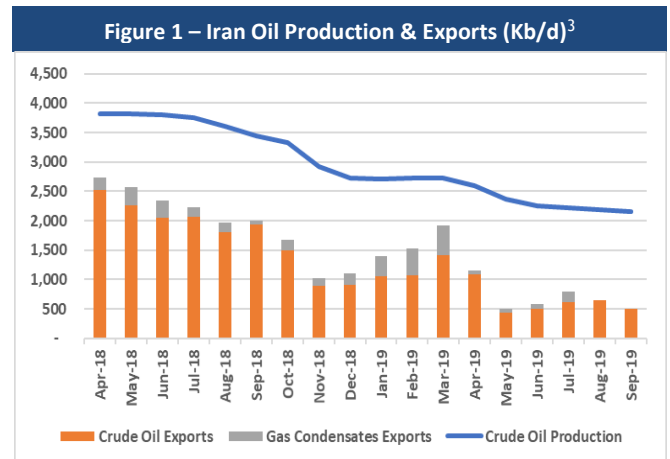
- The government's public pitch is that the economy has managed to stay afloat despite the pressures from the new US-led sanctions.
 - Iranian officials say that, excluding the oil sector, the economy grew by 0.4% in the last Iranian fiscal year (from late March 2018 to late March 2019). This was driven by the expansion in manufacturing and mining sectors, such as steel and copper.
- Economic relationships in the region have also strengthened despite the sanctions, with trade between Iran and its allies -- namely Iraq and Afghanistan -- continuing to be strong.
 - There is also potential for easing tensions between Shi'a Iran and its mainly Sunni regional GCC adversaries. Pakistani Prime Minister Imran Khan visited Tehran to mediate relations between Saudi Arabia and Iran.
 - Iranian Ministry of Foreign Affairs spokesman Abbas Mousavi indicated that Iran was willing to negotiate with the Saudis, with whom it is particularly at odds, over Yemen.
 - Meanwhile, Iran-Syria relations remain strong. The Iranian government announced that it is eager to assist in building Syrian power plants, transmission lines, and support in rebuilding the electricity network to potentially connect the two countries' grids through Iraq.

Iran's regional status quo threatened?

Anti-government protests in Iraq have challenged Iran's influence in the country.

- The initial demonstrations were over local grievances; however, they have become a protest against foreign intervention as Iran's presence has increased.
- Because much of the unrest is occurring in Shi'a majority cities like Baghdad and Basra, the protests seem, for the moment, to be cutting across sectarian divisions in the country.
- The protests prompted General Qasim Solemani, the leader of the Iranian Revolutionary Guards Quds forces, to visit Baghdad. In Tehran, Supreme Leader Ali Khamenei denounced protesters and voiced his opposition over Iraqi Prime Minister Adil Abdul-Mahdi's decision to resign because of the demonstrations.
- Iraqi protesters claim that pro-Iranian Hezbollah loyalists are taking part in the dispersal of gatherings and are responsible for clashes.
- Iraqi security forces opened fire on a crowd of protesters trying to break into the Iranian consulate in Karbala during the night of 3 to 4 November, killing three. We expect anti-Iran sentiment among protestors in Iraq to subside gradually after a new government is formed in Baghdad.

³ Crude oil production from OPEC Monthly Reports (Secondary Sources); Exports from Qamar Energy (Tanker Trackers).



Nuclear deal becoming harder to negotiate

We do not expect any material change in Iran's relations with Washington under the Trump administration, either diplomatically or militarily. The best-case scenario would be a constructive meeting that leads to other meetings, but we expect further escalation of regional tensions.

- In early November, Iran resumed uranium enrichment at its underground Fordow facility, a further step away from the JCPOA nuclear pact.
 - Iran had enriched about 10% of its uranium stockpile, above the 3.67% limit stipulated in the 2015 deal that the US has left.
 - It had also increased its stockpile of uranium beyond the 300kg limit in the international agreement.
 - These moves make any renegotiation of a deal harder, but they are not irreversible steps.
- The US has insisted the nuclear deal can only be revived if Iran renegotiates the terms of the accord, promises to end its "regional aggression" and curtails its ballistic missile programme.
- We note that "regional aggression" is not a straightforward concept. Iran can have leverage directly through financing proxies and indirectly through centuries-old influence and affinity (cultural and otherwise).
 - It is also not a one-way concept. The US could be accused of similar behaviour.
- The chance of some kind of meeting is high, but that of a good outcome from it is low under the current White House given that the US and Iran are miles apart in terms of world view and outlook.

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