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Dissecting the Impact of External Sanctions on Different Iranian Sectors

WWIC

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Introductory Remarks

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- Iran's economic developments have been undermined by sanctions, subsidy reforms, mismanagement and corruption;
- Growing unemployment, high inflation and low capital formation are all key indicators of a period of economic decline;
- However, different sectors have been hit to varying levels by sanctions;
- In this analysis, I will look at developments in some of the key sectors in the Iranian economy trying to understand the dynamics of internal and external parameters in the Iranian economy;
- It is important to underline that external sanctions are only one of the irritants in the Iranian economy. In addition to the above mentioned irritants, heavy domestic infighting and posturing for the upcoming presidential elections also contribute to economic uncertainties;
- The current deterioration of the Iranian economy is less a period of economic collapse and more a period of economic adjustment – however, the economy cannot settle down in the absence of internal and external continuity;

Perspective of the Average Citizen

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- The current economic conditions are very distressing for the average Iranian citizen;
- The degree of instability has reminded many citizens of the days of the Iraq-Iran war;
- Public anger is reflecting itself in sporadic unrest, strikes, blogshere protests, critical comments by artists etc.;
- Public discontent is so high that the senior clergy has also started to protest against the current economic conditions;
- While President Ahmadinejad blames the sanctions and “enemies” for the situation, the society is more nuanced and blames the Ahmadinejad policies as the main cause of the current economic misery;

Official / Unofficial Exchange Rates

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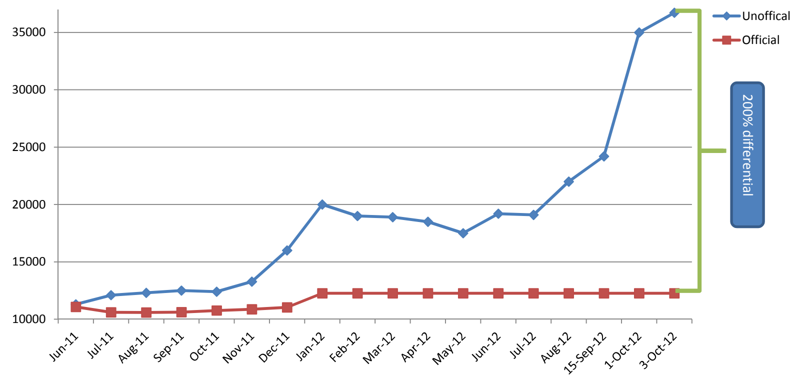
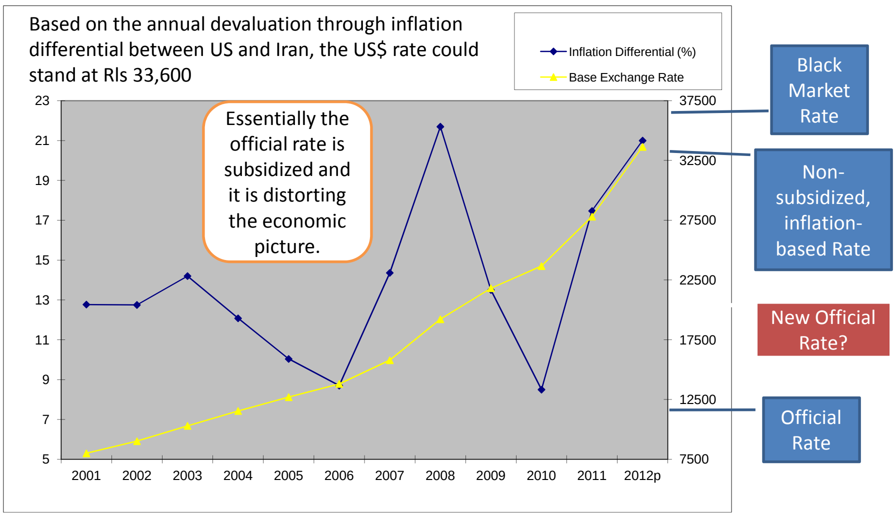
- The best indicator of how domestic business confidence is linked to political developments is the differential between the official and unofficial exchange rates;
- The following graph depicts the situation (official and unofficial Rial rates to the US$) since June 2011;



Can this be explained?

- The massive drop in the Rial value cannot just be understood through the analysis of pure economic phenomena;
- There are major economic, psychological and political reasons for the recent development, including:
  - Massive shift in the financial flows related to imports and exports;
  - Uncertainties about internal (elections) and external factors (war and sanctions);
  - Enormous growth of money supply as a result of subsidy reforms and banking sanctions (600% in 7 years);
- However, as will be explained later, a new and more realistic exchange rate could actually benefit segments of the Iranian economy;

The Imperfect Approach to determining the Rial-US$ exchange rate



Will the economy collapse?

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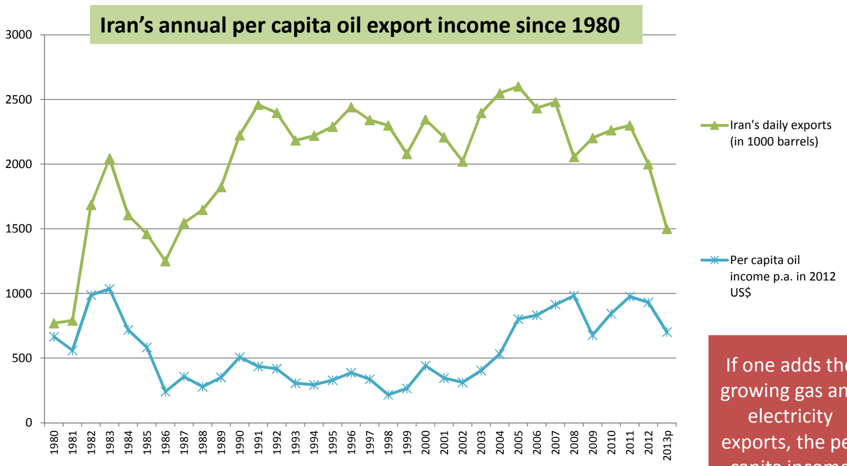

If one adds the growing gas and electricity exports, the per capita income will be even higher.

Sanctions, Trade and Exchange Rates

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- Banking and other sanctions have shifted a significant section of the Iranian trade away from official banking to the network of foreign exchange bureaus;
- The ever growing demand for such hard currency is related to large traders who settle their transactions in hard currency denominated contracts. In recent months, the government has stopped allocating official hard currency for a growing number of industries;
- The external sanctions have put a stop to commercial business of a large segment of the true private sector in Iran (the government and semi-governmental sectors have access to official hard currency);
- According to the latest estimates of the Central Bank, 21.6% of the Iranian economy is considered "underground economy" including growing smuggling activity to circumvent sanctions issues;
- Though the ongoing commitments of traders have pushed up hard currency prices, the market will find a new balance (similar to the past Rial value shifts);
- The new sustainable exchange rate will also determine the overall tendencies in imports and exports (more later).

A Closer Look at the Petroleum Sector

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- Oil export level has dropped to about 1.5 mbpd (down from 2.3 mbpd in January 2012) – this is more of a hiccup period and not a full crisis;
- The real crisis in the sector is a consequence of the currency devaluation and inflationary developments – letter from various associations to the Minister;
- Iran is trying to avoid driving down production which will have a medium-term negative impact on oil production in the country – NIOC is also engage in various fuel substitutions to shift export potential as gas and petroleum products are more easily marketable;
- The long term impact of the sanctions regime relate to lack of technology and lack of new investments which are undermining the long term sustainability of oil and gas production;
- Key stakeholders in Iran's petroleum sector know that the current situation is not sustainable and they will continue to lobby with key decision-makers;
- Iran's energy savings from subsidy reforms (up to 100 mcm/d) could eventually help increase oil production through gas injections;

Outlook for the Petroleum Sector

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- The current sanctions are slowing down the Iranian development in oil and gas, but they are also compelling Iran to become a producer (and eventually an exporter) of energy-related products and services;
- The current hiccups, especially the inflationary impact will further undermine the petroleum sector, but as the sector's revenues are in hard currency, it will find a new balance;
- While everyone is focusing on oil, the real story in Iran is gas. Despite sanctions and overall underperformance, Iran will add another 100 bcm/year of gas production capacity in the next 5 years;
- Furthermore, there will be domestic consumption savings as a result of subsidy reforms (potentially up to 35 bcm/year);
- The additional gas capacity will generate the potential of investments in gas-based industries with export potential;
- Another important outcome of the subsidy reforms could be that Iran would become a significant regional exporter of petroleum products;
- The growth of the sector (mainly due to subsidy reforms) will also make it more vulnerable to bargaining processes between political stakeholders;

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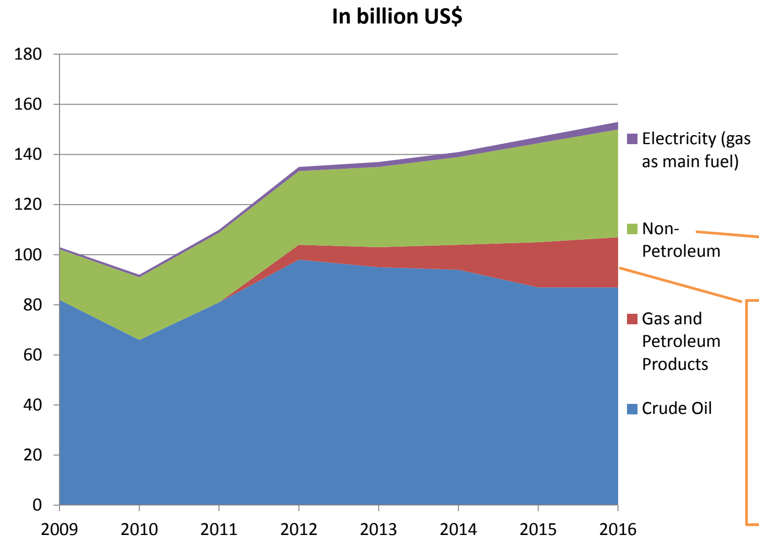
The growing Role of Gas in Exports



A growing segment of these exports are also gas-based.

This volume can grow further, if there are new pricing formulas for gas exports

Sanctions and Iranian Industry

- The Iranian industry is suffering extensively as a result of sanctions and negative economic phenomena;
- A recent study has shown that 80% of the Iranian managers view sanctions as the main obstacle to the development of their firm;
- The remaining 20% point to mismanagement and corruption as the key issue;
- Smaller industrial units are sandwiched between sanctions-related impediments and increased energy prices as well as inflation;
- Even large industrial units (such as the automotive companies) are suffering. Most companies have reduced production (up to 40% decline) and have had to make staff redundant;
- The representatives of the industry are demanding greater support from the government in the form of settling past dues, tax relief, hard currency allocations etc.;
- While the overall situation in the industry is grim, the devaluation of the Rial can lead to new opportunities, i.e.:
  - Imports will become more expensive which will empower domestic manufacturing;
  - Exports will become cheaper which should facilitate Iran’s non-oil exports.

Latest World Bank Report on Iran

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Below are some of the highlights from the World Bank's latest report on Iran:

- Iran's economy is transforming towards a market-based economy.
- Iranian state still plays a key role in the economy, owning large public and quasi-public enterprises which partly dominate manufacturing and commerce.
- The financial sector is also dominated by public banks.
- Iran's 2012 Doing Business ranking is in the bottom tiers of the MENA region ranking; 144th overall.
- The medium term outlook for economic growth is lower due to tougher sanctions and overall declining oil production.
- Export of crude oil is expected to decline due to embargoes by the EU and lower demand from China and India after recent payment difficulties due to the US sanctions on the Central Bank of Iran.
- Higher than expected inflation after subsidy removals are projected to depress private consumption.
- **The industry is also likely to struggle to adjust to higher energy prices also due to the sluggish provision of Government assistance which had been earmarked for the sector**.

Subsidy Reforms

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- From a socio-economic point of view, the subsidy reforms have been a disaster;
- The main losers have been the urban middle class;
- Reportedly, there have been some 500 to 700 thousand jobs lost in the agricultural sector (both due to cash handouts and also rising energy prices);
- The Iranian industry is suffering and a large number of industrial units are going bankrupt in the absence of the planned government subsidies to the industry;
- However, there are two important upsides that need to be taken into account:
  - The accumulated energy saving is expected to reach some 100 mcm / day (equal to $12 billion of annual export revenue for the economy);
  - Iranian companies, while under pressure in the short run, will have to become more competitive internationally;
- However, the consequent economic imbalance will continue for 2-3 years with many negative hiccups including high inflation and unemployment;

Key economic players and irritants

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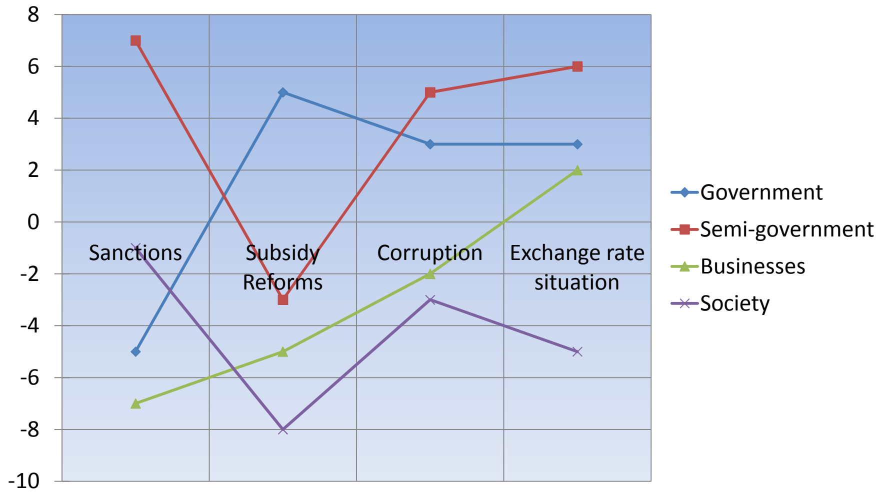

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Conclusions and Outlook

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- The Iranian economy will continue to suffer as a result of sanctions, subsidy reforms and domestic hiccups;
- Official inflation currently stands at 23%. Due to inflationary impact of the subsidy reforms and currency devaluation, inflation will rise further to about 30% by the end of the current Iranian year (20 March 2013). Unofficial inflation will be higher (about 35%). This will lead to social unrest, if the government does not find ways to compensate the society;
- The decline in oil export revenue will create short-term pressures, but not have a major impact on the government's overall financial position;
- Trade patterns will focus on key countries like China, India and Turkey – Iran will further limit its external trade and become more self-reliant;
- It is expected that the official USD-Rial exchange rate will be adjusted to Rial 20,000 and the unofficial rate will drop once a new balance is gained on the supply and demand side;
- The foreign exchange situation has facilitated exports, but also led to inflationary pressures.
- Businesses and the society remain the main losers of the current economic developments;
- The economic conditions will have direct impacts on the country's business interests. Therefore, economic interest groups will continue to push for a moderation in politics to safeguard their interests;
- A de-escalation in the nuclear stand-off won't be easy to achieve, but if it emerges after the US elections, it would boost the Iranian economy.

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