KfW Research
Emerging Markets Spotlight

››› Iran – the rocky road to sweeping economic renewal

No. 11, 2 March 2016

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Economic situation Real growth Private consumption (y-o-y) Inflation rate	**End of sanctions should revive the economy but oil price has a dampening effect** While the broad lifting of sanctions is very positive news for Iran, the persistently low oil price is putting pressure on the country's economy. Consequently, one can only hope that Iran will now experience a private consumption-driven growth spurt. Real GDP growth in 2015 was around 1–2 %. Double-digit inflation remains (14 % in 2015) and, although it is falling, is detrimental to all economic activity.
Growth financing Budget balance / GDP Current account balance / GDP Foreign debt / GDP	**Budget and foreign trade unproblematic but not very efficient** Oil and gas revenues are of high importance for the budget (minor non-critical deficit) and the current account balance (slight surplus). Oil export increases will further improve both indicators. Iran's foreign debt is extremely low as a consequence of the sanctions. Nevertheless, questionable subsidies, for example, and the split exchange rate create inefficiencies in the implementation of state measures and the use of export revenues.
Growth resources Investment rate Manufacturing share Labour market participation	**Low productivity and labour market participation** At 27 %, the investment rate is quite high and the manufacturing sector is growing faster than the agricultural and the services sector. However, these macro data mask the fact that manufacturing suffers from low productivity and outdated technology, so Iran is currently making insufficient use of its capital resources. The same is true of the country's workforce, as labour market participation, particularly of women, is very low.
Economic relations with Germany German share of goods exports German share of goods imports FDI inflows from Germany	**Trade and investment very modest as a result of the sanctions** Bilateral trade, which used to be significant, dropped sharply in the wake of the sanctions. Today Germany's imports from Iran are primarily food items, while exports to that country are primarily machinery. Recently German direct investment in Iran increased slightly in volume (reinvested profits) but is very modest overall.

Legend (see p. 5 for detailed explanation of methodology) very good good neutral weak very weak

Investment climate – assessment by our local experts

Iran is an emerging economy that owes this status not just to its oil and gas wealth but also to factors such as a diversified industrial structure and its population's high educational level. Years of sanctions over the nuclear programme, however, have caused significant damage to the country's economy, so expectations are very high now that they have been largely lifted. After Implementation Day, new prospects did in fact open up for Iran but the end of the sanctions is merely a necessary but not a sufficient prerequisite for fundamental economic improvements. Iran generally has high development potential but cannot realise it unless the business climate improves significantly. The government has declared its willingness to take action but the conflict between moderate forces and hardliners is still ongoing.

Continued on p. 2

Focus: Broad sectors of the economy are in urgent need of comprehensive reforms

In addition to creating favourable conditions for doing business, various specific reforms are needed in major areas. These include fiscal policy, where revenues need to be increased and inefficient subsidies eliminated, privatisation of industries, reducing government influence on and recapitalising the banking sector, as well as revitalising the labour market by increasing the participation of women and creating millions of new jobs. The government has announced reforms in a number of areas but which of them are actually implemented will have to be closely monitored.

Continued on p. 2

Investment climate: Assessment by our local experts

Implementation Day is a turning point but there is no reason to be euphoric just yet. Iran has been able to increase its economic output by 125 % since 1990 and evolve into an upper middle income country. It owes this achievement to its oil and gas wealth but also to its diversified industrial structure (see below). Years of sanctions from the West, which were toughened in 2012, have inflicted considerable damage on its economy and the country has recently fallen far short of its potential. The Joint Comprehensive Plan of Action (JCPOA) agreed in July 2015 between Iran and the E3+3 states (China, Germany, France, the UK, Russia and the USA) for resolving the conflict over Iran's nuclear programme has fuelled very high expectations in Iran for an improvement of its economic situation. Since the JCPOA was agreed and the sanctions were largely lifted in January 2016, however, Iranian investors and consumers have shown considerable restraint, which has negatively affected the economic recovery. It remains to be seen whether this restraint now dissipates quickly and the economic situation in Iran improves massively. The euphoria following Implementation Day on 16 January has been dampened by the fact that the low global crude oil price has come at the worst possible moment for Iran. Moreover, it must now first sort out the priorities on its extensive import wish list and the biggest hurdle for the foreseeable future will be access to finance. ECA coverage from Western partner countries should soon be generally possible but will initially require security such as guarantees from the Iranian Ministry of Finance or the Central Bank of Iran. Finally, choosing the right Iranian business partner will also play an important role.

Iran has distinctive strengths as a sales market and investment location. In addition to the already mentioned resources wealth and diversified economic structure, it has a large domestic market of 80 million inhabitants that includes a young population with high purchasing power and a pro-Western orientation, as well as low foreign debt and assets that are still frozen abroad. Another strength is its high educational level (see below).

The country also has considerable weaknesses, both economic and political. Apart from the unfavourable environment in important areas outlined below, the poor business climate deserves particular mention. This is impressively confirmed by Iran's position 118 on the Doing Business Index, which rates 189 countries, and position 130 of 167 countries on the Corruption Perception Index. In general, it is important to be mindful that the clerical rulers think primarily in political and not economic categories. Furthermore, important stakeholders benefit from the status quo and are therefore not interested in reforms. The controversy over the direction of economic policy between moderate forces and hardliners is still ongoing.

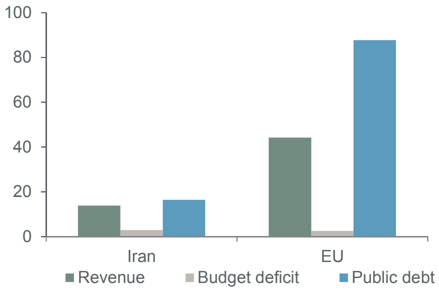
Based on an interview conducted with Sebastian Fenk, KfW IPEX-Bank Abu Dhabi Office Director, on 3 February 2016. ■

Focus: Radical improvements will not come about without broad reforms in almost all economic sectors

Fiscal policy. The government has little scope for action because public revenue is only 14 % of GDP (EU 44 %, Figure 1). Iran needs to increase its public revenue and has already taken steps in this direction by raising VAT, improving tax administration and removing tax exemptions. On the expenditure side, in order to create scope for more public investment, the government should change the inefficient system of subsidies, which allows cash transfers to every Iranian without a means-testing requirement. What deserves recognition is that Iran has responded to the decline in oil price with a prudent budget policy since 2014 (while other Gulf states amassed increasing fiscal deficits). After the end of the sanctions, higher oil exports and the recovery of assets frozen abroad also result in a positive budget outlook. The 2016/2017 budget was calculated on the basis of an oil price of USD 40 per barrel. Whether this price is realistic remains to be seen.

Figure 1: Key budget figures for Iran in comparison with the EU

In per cent of GDP, 2015



Source: IMF

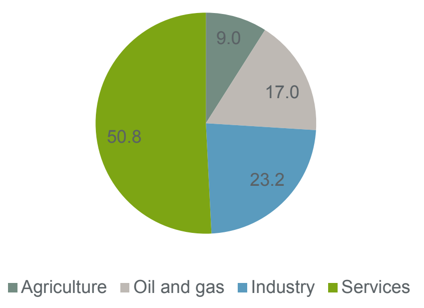
Industry and infrastructure. In addition to the oil and gas sector, which predominates with a GDP share of 17 % (Figure 2), but is less important than in Saudi Arabia, for example (43 %), Iran has an industrial sector with a fairly high degree of diversification (automobiles, petrochemicals, construction, food processing). The country is heavily dependent on imported plant and machinery in both industry and infrastructure (energy supply, transports, communications, water). It was not just the sanctions but also the strong devaluation of the rial that made imports more difficult, left the means of production severely outdated and led to a shortage of spare parts. Total capacity utilisation is estimated at only around 50 % or even less, so the need for modernisation and expansion in industry and infrastructure is enormous. Business climate and privatisation of existing enterprises are other items that should also be on the reform agenda.

The banking sector. Every market economy needs healthy and functioning banks and this is where Iran has considerable deficits. The sanctions are partly responsible, especially as the disconnection from the SWIFT mechanism massively disrupted foreign payments and blocked foreign assets. However, the weaknesses of the banking sector are also home-made. Most of the banks belong to the state or are subject to strong government influence. They are undercapitalised and achieve low returns (Figure 3). Excessive forced dividend pay-outs undermine their equity. Lending is government-controlled and favours the public sector, which often fails to service its debt. The officially reported rate of non-performing loans is around 14 %, but is in fact probably higher, and risk provisions cover only about one third. Regulation and supervision of financial institutions by the Central Bank of Iran, which is not independent, is weak. The government has promised sweeping sector reforms but the forces of inertia are likely to be strong.

Education and the labour market. The educational level of the population is comparatively high. More than one quarter of the Iranian workforce has a secondary school education and nearly 20 % a university degree (Figure 4, more current data are not available). Industry relies on a skilled workforce. Iran has a very young population, with 40 % below the age of 25, but labour market participation is very low. Only 48 % of the working-age population is employed or seeking employment and the participation of women is even as low as 18 %. In the peer group of upper middle income countries, these figures are 73 and 62 %, respectively. This means Iran is failing to use a considerable portion of its labour potential. Today the labour market is faced with a problem of a somewhat different nature, however. Around 20 % of the workforce is unemployed or underemployed and three million young Iranians will enter the labour market in the next five years. In the past 20 years, new jobs were created primarily in the construction industry. In order for employment to shift to high-value manufacturing and service jobs in the future, the business climate must improve substantially in this regard as well. ■

Figure 2: Economic structure

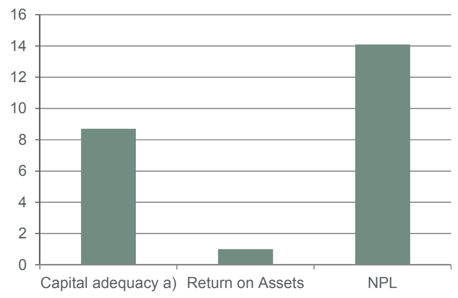
2013 / 2014, in per cent



Source: Central Bank of Iran

Figure 3: Key figures on the Iranian banking sector

2013, in per cent

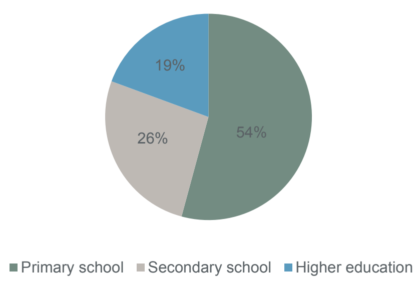


a) Risk-weighted assets as a ratio of equity

Source: IMF

Figure 4: Educational level of the workforce

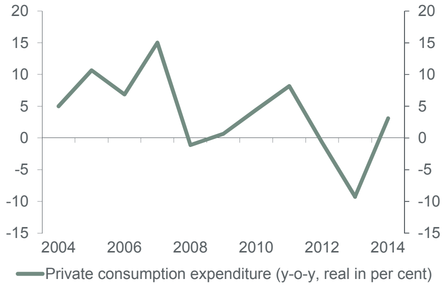
As 2008

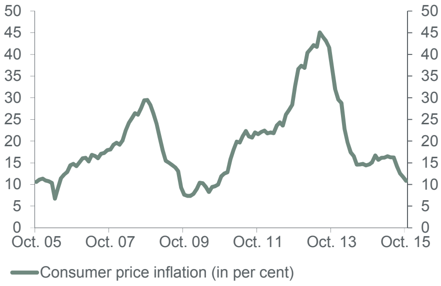


Source: World Bank

Overview of figures

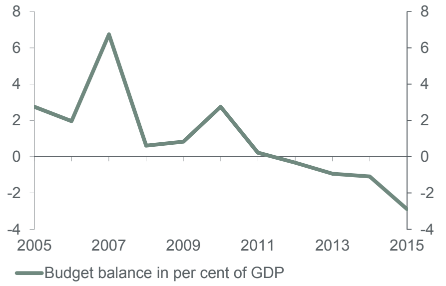
Economic situation

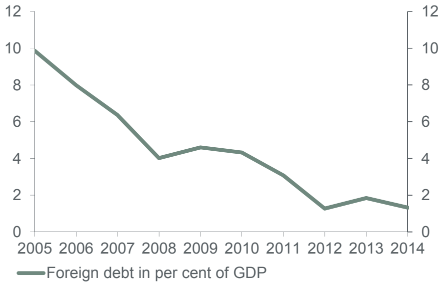




Source: Datastream; IMF, Worldbank; own calculations

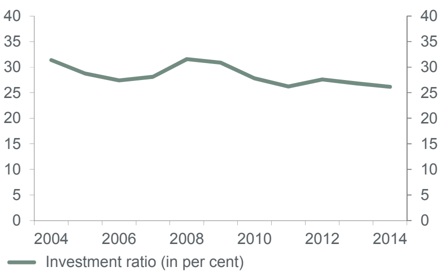
Growth financing

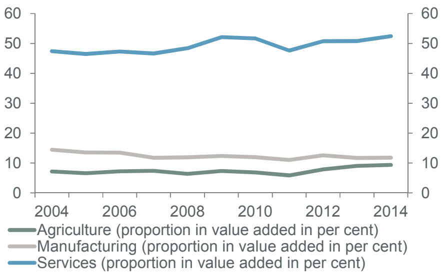




Source: Datastream; IMF, Worldbank, Central Bank of Iran; own calculations

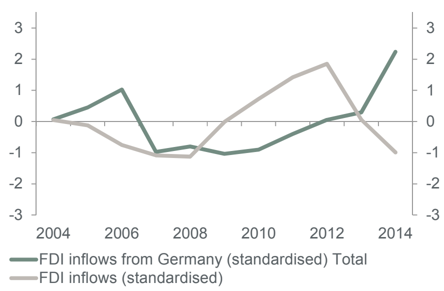
Growth resources





Source: Datastream; Worldbank

Economic relations to Germany



Source: Deutsche Bundesbank; Datastream; IMF; UNCTAD; own calculations

Methodology

In the Emerging Markets Spotlight, a selected country is analysed based on various macroeconomic indicators. These indicators are grouped into four categories: economic situation, growth financing, growth resources and economic relations with Germany.

- Quintile 1
- Quintile 2
- Quintile 3
- Quintile 4
- Quintile 5

The indicators are used to compare the country's situation with its peers. The group comprises Brazil, China, India, Indonesia, Mexico, Russia, South Africa and Turkey. The comparison is based on a quintile ranking in five categories, which are labelled in different colours (see chart):

The country is assigned to a quintile of the country group for each indicator analysed. The best quintile may be different for each indicator. For example, higher growth rates are better, so here the upper quintile is coloured dark green, but higher debt rates are a negative factor, so here the upper quintile is coloured dark red.

Disclaimer

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