Iran has escaped from the severe recession that threatened its economy in 2012 and early 2013. As previous Roubini Global Economics (RGE) and Foundation for Defense of Democracies (FDD) reports have assessed, Tehran has used the sanctions relief from the Joint Plan of Action (JPOA) interim agreement, reached in November 2013, and the resulting improvement in market sentiment to stabilize its economy and build up economic resilience against future sanctions pressure. This economic recovery comes as Iran and the P5+1 international negotiating teams are involved in another round of talks, extended for the second time to June 30, 2015, with the goal of reaching a comprehensive nuclear agreement. So far, however, Iran’s Supreme Leader Ali Khamenei has rejected all of the West’s compromise proposals.

With the recent 60%-drop in the price of oil—Iran’s most valuable commodity, which dominates exports and revenues—negotiators are hoping that this shock to the Islamic Republic will provide more meaningful economic leverage. As it turns out, however, Iran experienced its own asymmetric oil shock three years ago and has had time to adjust to the painful impact of decreased oil exports and restricted access to its overseas oil revenues. Beginning in 2012, U.S. legislation required Iran’s oil buyers to significantly reduce their oil purchases; Iranian exports dropped from about 2.3 million barrels per day (bpd) to just over 1 million. In February 2013, U.S. sanctions began locking up Tehran’s oil profits through a little-understood provision imposed by congressional sanctions legislation. The provision required countries buying Iranian oil to pay for their purchases in escrow accounts in a handful of countries: China, India, Japan, South Korea, Turkey, and Taiwan. The funds were then available to Iran, but only for purchasing local goods from those countries or humanitarian goods from others.

The scheme worked well for Iran’s main oil buyers, who could still buy approved quantities of Iranian oil without sanctions penalties (as long as they were significantly reducing those purchases over time) and at the same time

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1. This analysis is coauthored by the FDD’s Center on Sanctions and Illicit Finance and Roubini Global Economics. As an independent economics research firm, Roubini Global Economics does not take a view on which policies the U.S. should adopt with respect to Iran. FDD is a non-profit, non-partisan, policy institute whose experts have written extensively on U.S. policy toward Iran. Both organizations believe that a better understanding of the impact of sanctions on Iran’s economy can help inform policy choices.

Jennifer Hsieh is an economist with Roubini Global Economics. Rachel Ziemba is senior director of Roubini Global Economics’ Emerging and Frontier Markets. Mark Dubowitz is executive director of the Foundation for Defense of Democracies (FDD) and heads its Center on Sanctions and Illicit Finance (CSIF).
boost their exports. It didn't work so well, however, for Tehran. The Iranian government couldn't repatriate any of the existing oil funds sitting in these overseas escrow accounts, estimated to be over $100 billion. The monthly oil revenues collecting in these accounts could not be spent down fast enough because Iran could not find enough non-sanctionable goods that it wanted to buy from those six countries (Europe, which was Iran's preferred shopping zone, had become far more restrictive). In fact, the U.S. Treasury Department estimated that Iran could only spend about half of its recurring monthly oil revenues on imports in 2013, leaving the rest to pile up in escrow.\textsuperscript{2}

By 2012 and early 2013, as a result of sanctions that hit these oil revenues, curtailed Tehran's access to the formal financial system including the SWIFT (Society for Worldwide Interbank Financial Telecommunication) global financial messaging system, and blacklisted key sectors of the Iranian economy (for example, automotive, petrochemicals, ports management, shipping, and shipbuilding), Iran's economy was in a severe recession marked by negative growth, a plummeting currency, and hyperinflation. Iran's fortunes, however, changed in November 2013 after Iran and the P5+1 reached an interim nuclear agreement. Under this agreement, beginning in January 2014, international negotiators agreed to return an average of $700 million per month to Iran from these semi-restricted oil escrow accounts. By June 30, 2015, when the current extension of the interim agreement is set to expire, Tehran will have received about $12 billion from these escrow accounts to spend however it desires. In addition to these payments and other forms of direct sanctions relief, the Obama administration also put the brakes on the further escalation of U.S. sanctions and helped Iran recover from its severe recession to reach modest growth, a stabilization of the currency, and a halving of the inflation rate.

To be sure, as this report assesses, the drop in the price of oil (and the supply shock it represents) will be a drag on Iran's economy. Growth is estimated to slow in fiscal year 2015/16, and the new Iranian government will be forced to cut government spending and increase tax revenues. Lower oil prices could also diminish the enthusiasm of energy companies contemplating a return to the Iranian energy sector, even if the ongoing nuclear negotiations lead to permanent sanctions relief. Even black-market oil deals will look less attractive now that buyers can purchase cheaper oil without engaging in illegal sanctions busting.

Despite all of this, the recent growth in Iranian non-oil export earnings and overall better management of the economy by Iranian President Hassan Rouhani's team will help cushion the economy against falling oil prices.

The Islamic Republic has weathered three difficult years of sanctions with rapidly declining oil exports and two years without full access to its overseas oil revenues. Today, in a strange twist of fate, these restrictions blunt the full impact of the drop in oil prices on Iran's economy. As this report assesses, the drop in oil prices will be insufficient to precipitate the kind of economic crisis that drove Iran to the negotiating table in the first place. Oil markets, however, are well supplied to withstand greater reductions in Iranian oil exports and provide U.S. lawmakers with more favorable conditions to impose the rapidly escalating sanctions necessary to hit Iran's economy with further asymmetric shocks.\textsuperscript{3} If these sanctions are successfully implemented, they may once again reanimate the fear the regime felt in 2012 and 2013 when it narrowly escaped a severe economic crisis. Such conditions may improve Western negotiating leverage and increase the chances of a successful, comprehensive agreement that verifiably stops Iran's march to nuclear weapons capacity.


Summary of Analysis

• As Iran and the P5+1 resume nuclear negotiations, we take the opportunity to assess the Iranian economic outlook for the next two years under a hypothetical scenario in which negotiations are perpetually extended. We also gauge the impact of meaningfully lower oil prices (which have more than halved since RGE’s last note4) on the Iranian economy.

• Bottom line: Although recent developments in the global oil market will curb economic growth and stoke inflationary pressures within Iran, further extension of the Joint Plan of Action (JPOA) would allow Iran's economy to continue to grow. Paradoxically, sanctions on Iran disrupt some of the normal channels through which oil prices usually affect the economies of major energy producers and mitigate the immediate consequences of plummeting prices for the Iranian economy. Still, considerable deterioration in the oil price outlook will be particularly noticeable in a weaker currency, moderate fiscal drag, and reduced oil export growth as Iran's trading partners have plenty of alternatives in a well-supplied oil market.

• Strong public investment leads us to upgrade the forecast for fiscal year (FY) 2014/15, ending March 20, 2015, to roughly 3.0% from 2.5%5 (and this estimate remains conservative, in our view). Over our forecast horizon, we assume no meaningful change in the sanctions regime and a recovery of oil prices beginning late 2015. Under these assumptions, we see continued but more muted growth in 2015/16, as temporary supports fade. Under these assumptions, we see continued but more muted growth in 2015/16, as several of the current year's key growth drivers prove temporary—including pent-up demand and a bounce in construction (coming off a very low base). We expect a moderate acceleration in 2016/17 as oil prices pose less of a drag but the persistence of sanctions constrains long-term investment. Under this baseline, inflation will rise from 15.1% in 2014/15 to above 20% in 2015/16, as fiscal and monetary conditions remain relatively tight, but greater depreciation of the rial (to help compensate for weaker oil prices), government borrowing, and supply shortages boost price pressures.

Key Takeaways

• Economic performance in the next fiscal year depends heavily on the outcome of talks in the months leading to the June 30, 2015 deadline (and potentially thereafter). Here, our economic “baseline” assumes a perpetual JPOA—namely further extension of negotiations and a protracted rollover of current relief measures. While such a situation is unsustainable over the long-term, it should serve as a starting point to evaluate the economy’s sensitivity to further changes in oil price and to gauge the impact of potential risks.

• Declining oil revenues amplify economic pressure but do little to reverse the near-term benefits of sanctions relief. By limiting Iran's access to most of its oil revenues, sanctions cushion the immediate effects of oil price drops on Iran's economy. We doubt weaker oil prices would trigger a balance of payments crisis or massive devaluation of the black-market exchange rate (to the extent seen in 2012/13). Iran has largely adjusted to the foreign financing shock, and the falling dollar value of exports will have a less meaningful impact on Iran's ability to import than in the past. At this point, imports are more meaningfully constrained by restrictions on the use and repatriation of reserves.

• **Lower oil prices do bite, albeit less than in a no-sanctions environment.** The global oil glut lessens incentives for Iran's buyers to cheat sanctions—meaning oil exports, including condensates, will be more modest than we previously envisaged. Lower oil revenues will also bring about greater fiscal restraint, curbing public investment and prompting further devaluation of the official exchange rate (to compensate for lost oil revenue in local currency terms). The government, however, has already taken steps to reduce its budget reliance on oil revenues. Meanwhile, the lower value of exports erodes balances in select import markets, driving up the rial price of hard currencies on the black market and threatening to create supply shortages. On balance, this will not only constrain 2015/16 growth but also bring inflation back above 20%.

• **A longer-term slump in oil prices and global energy demand would weigh more heavily on Iran's medium-term economic outlook.** Aside from bleaker long-term prospects for the energy sector, an extended glut would keep foreign investors at bay. Many international oil companies have put a moratorium on investment globally, meaning that Iran would have to roll out extensive incentives even in the event of a nuclear deal. Lower oil prices for longer would also necessitate greater fiscal and structural adjustment to further broaden government revenues away from oil income, particularly should sanctions continue to impede export volumes. Over time, Iranian demand for imports will increasingly erode the cash balances in certain escrow accounts—creating shortages.

• **Recent data shows growth recovered and broadened in 2014.** Final GDP data indicates the economy grew 3.8% y/y in fiscal Q1 (March 21- June 21, 2014) and 4.5% y/y in fiscal Q2, which marks a significant improvement from the -2.2% y/y rate in the last quarter of FY 2013/14. The breakdown of GDP shows that Iran's economic recovery had broadened to domestic demand (consumption and investment) and the more labor-intensive service industry—vindicating our long-held claims that such a recovery was imminent as the slower-moving benefits of sanctions relief increasingly emerged. However, the economy is still growing below its long-term trend and recent data paints a more mixed picture as overall sentiment has ebbed in recent months on lower oil exports and scant progress toward a final agreement in nuclear talks. [See Appendix for a review of recent data].

• **The economy will continue to grow under current sanctions, but a final agreement is needed to sustain the recent pace of expansion over the longer-term.** Sanctions relief, improved sentiment, and better economic management have already fostered an economic turnaround, but a sustained, robust rate of growth will require a permanent deal to unlock investment and facilitate greater oil export volumes—factors which are increasingly important in a low oil price environment. On the flip side, measures to cap oil exports or tighten sanctions would lead to a steeper deceleration in 2015/16, and possibly a renewed recession.

• **Risks remain to our FY 2015/16 and 2016/17 outlook which are broadly unrelated to the outcome of nuclear negotiations.** These include (1) uncertainty surrounding the path of oil prices and the effect on export volumes and overall sentiment; (2) a material surprise in 2014/15 data, which is released with a delay and subject to frequent revision; and (3) a shift in the government's policy of maintaining price stability which dictates its response to falling oil prices.

7. Readers should view this analysis as a thought exercise. All forecasts, particularly beyond this fiscal year, rely on a set of assumptions and projections which, while consistent with our scenario, will vary from the ultimate outcomes, even should our baseline of continued negotiations prove true.
Iran’s economy will slow but continue to grow under cheaper oil and current sanctions

**Figure 1: Summary of Macroeconomic Variables Under Perpetual JPOA**

<table>
<thead>
<tr>
<th></th>
<th>2011/12</th>
<th>2012/13</th>
<th>2013/14</th>
<th>2014/15 (f)</th>
<th>2015/16 (f)</th>
<th>2016/17 (f)</th>
</tr>
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<tr>
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<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Real GDP</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Growth (%)</td>
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<td>1.5-1.8%</td>
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<tr>
<td>Growth (%)</td>
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<td>-2.6%</td>
<td>-0.6%</td>
<td>2.9-3.2%</td>
<td>0.8%-1.2%</td>
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<tr>
<td>Average</td>
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<td>Exchange Rate (IRR/USD, avg)</td>
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<td>12,260</td>
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<td>26,250</td>
<td>29,200-31,000</td>
<td>31,000-34,500</td>
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<td>30,300</td>
<td>36,600-39,000</td>
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<td>Reserves (bil. USD, eop)</td>
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<tr>
<td>Total</td>
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<td>105</td>
<td>123-126</td>
<td>130-136</td>
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<td>25-30</td>
<td>27-32</td>
<td>30-40</td>
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<td><strong>Per-Capita (central forecast)</strong></td>
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<td></td>
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<tr>
<td>Real GDP</td>
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<td>96.4</td>
<td>94.8</td>
<td>96.6</td>
<td>96.4</td>
<td>97.5</td>
</tr>
</tbody>
</table>

**Sources:** Jutab Marin International Consulting Co., Haver Analytics, Bloomberg, International Monetary Fund, and Roubini Global Economics

**Lower Oil Prices Bite, but Sanctions Blunt the Effect**

It is important to understand the extent and channels through which collapsing oil prices currently affect Iran. We maintain that a longer-term decline would be more concerning, given that some sanctions elements paradoxically leave the Iranian economy with a greater short-term resilience to oil price shocks. Nevertheless, the deteriorating outlook for oil prices still weighs on near-term growth in various ways. Most importantly, it undermines Iran's ability to increase oil exports while also reducing government revenue (and thus, willingness to spend).

Iran's foreign revenues from energy products are captured in escrow accounts, mitigating the direct pass-through from a decline in oil prices to the Iranian economy. Iran has thus far struggled to fully utilize its overseas reserves. To the extent that total exports remain above the value of imports or transfers allowed by the JPOA, cheaper oil would simply imply a slower accumulation of reserves in semi-accessible accounts until prices recover or a final agreement is reached. In fact, our baseline sees total reserves flattening temporarily in mid-2015, but otherwise rising through the forecast period. As such, we see little chance that falling oil revenues could spark a balance of payments crisis and massive devaluation of the rial of the scale seen in FY 2012/13.
Weaken Only Marginally Next to Plummeting Oil Prices

Sources: Jutab Marin International Consulting Co., Haver Analytics, Bloomberg, and Roubini Global Economics

This is not to say that the economy is invulnerable. We now expect Brent to average roughly $62 per barrel in FY 2015/16, nearly 30% below the current fiscal year and well short of the $72 base price included in President Rouhani’s December draft budget bill, now set at $40 per barrel. (The estimate had seemed cautious at the time). Escrow accounts are not airtight since Iran has abused these accounts, for example, through sanctions-busting schemes in Turkey involving “gas-for-gold” and fraudulent humanitarian transactions. Further, meaningfully weaker oil prices undermine Iran’s macro outlook via: (1) lower oil production; (2) a weaker official exchange rate; (3) reduced public investment due to greater fiscal restraint; and (4) potential decline in import accessibility. They also weigh on consumer and investor sentiment, reduce the prices at which Iranian oil projects (downstream) are reimbursed domestically, and could increase the demand for refinancing from various local entities.

8. The real exchange rate is calculated from the black-market exchange rate (eop), adjusted for the U.S./Iran consumer price index differential. An increase in the exchange rate reflects appreciation of the rial against the USD when adjusted for the relative price of goods.
• **Lower oil production:** Under the current sanctions regime, and given tepid global demand, we doubt Iranian oil output will increase much in 2015/16. There are plenty of alternatives for Iran's crude oil (particularly Saudi Arabia which has a similar range of oil blends), and a global oil glut means Iran's buyers have less incentive to cheat sanctions and increase imports absent a more significant price discount. Since August 2014, liquids production has stagnated rather than accelerated. As a result, we see Iranian production flat-lining and rising only gradually in the second half of 2015 as global prices stabilize and rise slightly on evidence of supply restraint, particularly out of the United States.

• **Weaker official exchange rate:** The December draft budget bill (now under revision) included an average official exchange rate of 28,500 rials per dollar in FY 2015/16 (from around 27,500 currently). Such a devaluation would partly offset Iran's falling USD oil revenues in local currency terms; however, our forecasts warrant an even weaker rial. All things being equal, a $62 oil price creates a roughly 3-4% revenue shortfall relative to the draft budget which assumed a $72 barrel. An official exchange rate closer to 32,500 (average) could bridge this gap and would bring official and black-market exchange rates closer to unity, but would prove inflationary—thus the government is unlikely to rely on exchange rate devaluation alone.

• **Greater fiscal restraint:** We expect oil revenues to fall roughly 20-25% y/y in FY 2015/16, implying a roughly 8-9% decline in total revenues relative to FY 2014/15. The government has substantially reduced its reliance on oil revenues in recent years, and officials have revealed that the revised 2015/16 draft budget will be based on $40 per barrel oil. Beyond currency devaluation, Iran's government will likely compensate for the decline with a variety of measures including a VAT hike and limits to growth of current expenditures. While oil prices should rise considerably in 2016, heightened uncertainty surrounding prices will compel the government to exercise restraint, delaying the start of multi-year investment projects.

• **Potential decline in imports access:** At first glance, declining oil revenues ought to have little near-term effect on Iran's ability to import as a whole, as it has accumulated a sizable external balance which can be run down for some time as the dollar value of oil exports fall. However in practice, Iranian import demand is imbalanced, leaving Iran with sizable balances in countries from which it finds little to buy (Japan), while it exhausts balances in countries from which import demand is greatest (China). Although restrictions on transfers (permitted only for humanitarian goods) may not be airtight, Iranian officials are increasingly cautious about imports lest they run down their reserves. Falling balances in key import markets could soon put pressure on fully accessible reserves and the black-market exchange rate, and ultimately create import shortages.

On balance, we see a moderately negative effect on 2015/16 growth—through flat oil production and limited public investment. A weaker exchange rate, VAT tax hikes, and government borrowing will have inflationary effects—although weak (or negative) real public wage growth will help counteract these pressures. A shift in policy preferences away from price stability, and marked by less fiscal restraint, poses upside risks to our growth and inflation forecasts.
Baseline Forecast: Growth Will Moderate Without a Final Agreement

Under a hypothetical, no-change scenario, where negotiations and JPOA relief measures are extended through fiscal 2015/16, Iranian growth will remain positive but slow somewhat to 1.5-1.8% in FY 2015/16 as temporary supports fade and the economy remains constrained by a lack of foreign investment and declining oil revenues. Pent-up demand, positive base effects, and the diversion of savings toward consumption and more productive investments are partly responsible for the recent rebound in domestic demand. As these temporary factors subside and energy exports idle under global oversupply, growth will shift into lower gear. Our sentiment indicator (generated using RavenPack News Analytics’ proprietary natural language processing software) has dipped in recent months, as negotiators failed to reach a final deal, oil prices plunged, and optimism around domestic politics has faded. This confluence of circumstances supports a slowdown of growth.

We expect private consumption to drive growth through 2016/17. Though this hints at a turnaround for “average” Iranians, 5.6% growth over a three-year period still leaves per-capita consumption (public + private) 2.5% below 2011/12 levels—meaning that after five years, Iranian standards of living still will not have improved. Real fixed investment should idle just above 26% of GDP annually, a slight improvement from 24.9% of 2012/13, but otherwise lower than any other year since 2003/04. We estimate that real investment at the end of our forecast period (2016/17) will have risen to only 80.1% of its 2011/12 levels. Additionally, to the extent that rising consumption and investment stems from stronger external purchasing power and rising imports, local businesses and employment will benefit less. Net exports will drag on growth as imports maintain their recent course and non-oil exports fail to compensate for lower oil sales.

12. High y/y growth reflects the comparison to a weak quarter in the previous year. Seasonally adjusted growth in the base quarter, Q1 FY 2012/13, was estimated at -7.7% q/q by Haver Analytics.
Iran's economy will slow but continue to grow under cheaper oil and current sanctions.

**Figure 4: Domestic Demand to Drive Growth Over the Forecast Period (p.p. Contribution to Real Annual Growth)**

Sources: Haver Analytics and Roubini Global Economics

**Figure 5: Standards of Living Stall Under Sanctions (Real Expenditures, 2011/12=100)**

Sources: Haver Analytics and Roubini Global Economics
The gradual recovery of oil prices in late 2015 and 2016 will foster an improvement in confidence and allow the government to loosen its purse strings—if only a little. Growth should improve to around 2.1-2.5% in 2016/17.

In short, Iran will struggle to maintain recent growth rates (above 3.0%) over the longer-term, close the output gap, or materially lift per-capita incomes with current sanctions in place. Without access to foreign capital, investment must be funded entirely from domestic savings. Considerable government borrowing continues to crowd out private investment and borrowing from local banks. However, absent an increase in the repatriation of oil proceeds, fiscal adjustments will stem from either a reduction in public expenditures (hitting growth) or from tax hikes (which reduce private disposable income).

Fiscal Shortfall Will Weaken FX and Inflation

We expect further depreciation of the official exchange rate in 2015/16, driven in part by the need to bridge the shortfall of public revenues in local currency terms. Without a meaningful change to sanctions, we see the official rate depreciating beyond the 28,500 rials per dollar figure in Rouhani’s proposed budget (towards 29,200-31,000 on average) as slightly higher export volumes fail to make up for weaker oil prices. More depreciation is likely if the government makes good on its plan to unify official and black-market exchange rates in 2015. Under our baseline of continued sanctions, dollar strength, still-elevated inflation, and a shortage of fully accessible reserves, we see a stronger depreciation of the rial on the black market—from 36,600 to 39,500 on average in 2015/16.

Inflation should rise in FY 2015/16, crossing back above 20%. This increase reflects depreciation of the rial, a moderate rise in domestic fuel costs, and the planned VAT tax hike. Inflation has already begun to pick up and anecdotal reports suggest that food prices in urban areas have risen substantially over the last few months.

Inflationary pressures are, however, a far cry from the 2012 levels, and risks of hyperinflation are misplaced. However, adjusting to the lower oil price will mean higher prices and weaker growth, keeping Iran at risk of stagflation, a condition it has experienced for most of the last decade.
Iran’s economy will slow but continue to grow under cheaper oil and current sanctions

Figure 7: Expect a Modest Rise in Inflation and Average Exchange Rate

Source: Jutab Marin International Consulting Co., Haver Analytics, and Roubini Global Economics

Key Risks Under the “Baseline” Scenario of a Perpetual JPOA

Setting aside the numerous potential outcomes of the nuclear negotiations, there remains considerable uncertainty over the path of other key drivers largely unrelated to sanctions. As such, we have highlighted a number of factors that pose risks to our baseline forecast, even absent a meaningful change in the sanctions regime.

1. A material surprise in 2014/15 data: Although much of the year has passed, economic data is released with a lag and is subject to revision. Our 2015/16 forecasts are conditional on our expectations for a moderate recovery this current fiscal year, and particularly on a positive trend in non-oil GDP and improving domestic demand. The upside surprise in Q2 growth (4.5% y/y) owes largely to a temporary surge in fixed investment, which will fade next year. However, a positive near-term surprise in private consumption, employment, and incomes could build a case for stronger private spending as the government reigns in its investment plans next year.

2. The price of oil may confound our forecast, as could its effect on Iranian export volumes and energy sector production. Our view that Iran will strive to maintain its market share underlies our projection of flat exports and oil production in 2015. However, lower oil exports are a distinct possibility as oil prices bottom and trade partners (like China) slow their accumulation of energy reserves.
   a. Notwithstanding sanctions, the energy sector still accounts for roughly 10% of real GDP. Other things being equal, a sharp and immediate drop-off in oil exports to just above 1.0 million bpd, could weaken growth to 1.0-1.5% in 2015/16 due to falling energy sector production, lower confidence, and cutbacks to public investment plans.
   b. The projected recovery of oil prices in late 2015 guides our view of accelerating growth in 2016/17. However, a more immediate U-shaped rebound in oil prices (to $80 by end-2015) would imply better oil exports and less drag from public investment in the near term. Average oil prices of $76 per barrel could bring growth closer to 2.0-2.5% for fiscal year 2015/16.

14. The average exchange rate is calculated here as a weighted sum of the official IRR/USD rate (60%) and the black-market exchange rate (40%).
(3) Change to Iranian policy response mechanism: We believe that the government will continue on its recent course—focusing on price stability by keeping to a relatively tight monetary and fiscal stance. Given that oil revenues continue to accrue in escrow accounts, albeit at a slower rate, we assume that the sharp fall in oil revenues will result in little change to current spending but will compel the government to curb public investment plans and opt for a larger-than-expected depreciation of the official exchange rate. Conversely, growth could be marginally stronger if the government opts to increase spending (although it is unlikely to adopt the spendthrift policies and sky-high inflation rate of its predecessor).

**APPENDIX: RECENT DATA CONFIRMS DOMESTIC RECOVERY, BUT HINTS AT A SLOWDOWN AHEAD**

Final GDP data shows the economy continued to build steam through the first half of fiscal year 2014/15 (ending September 22, 2014). Year-on-year growth accelerated for the second consecutive quarter to 4.5% y/y in Q2 of FY 2014/15, putting growth at 4.2% y/y for the entire first half of FY 2014/15. Indeed, the sharp rebound owes partly to positive base effects, pent-up demand, and carry-over effects of a rebound in the second half of 2013/14. Nevertheless, the composition of growth is broadly positive.

We have long argued that the upward creep in oil exports, improved confidence, and stabilization of the rial last year—related to sanctions relief and better economic governance—would pass through with a lag, facilitating a recovery of domestic demand which would become evident early this year. However, the 6.9% y/y rise in domestic demand in the first half of FY 2014/15 exceeded our expectations, driven by a surge in summer construction. Fixed investment contributed 3.3 percentage points to GDP growth in the first half of FY 2014/15, rising an eye-opening 26.3% y/y in the second quarter, the fastest pace in almost two decades (albeit coming off a very low base). Final sales\(^{15}\) growth continues to exceed that of production, suggesting that less drag from inventories will prove supportive of growth moving forward.

**Figure 8: Inventories Drag on Growth (Real y/y Growth, Market Prices)**

![Inventories Drag on Growth](image)

*Sources: Haver Analytics and Central Bank of Iran*

\(^{15}\) “Final sales” is gross domestic production less the accumulation of inventories.
The pace of domestic demand growth can be expected to moderate after an initial rebound. This prediction is supported by a moderate decline of domestic sentiment in late 2014 (on falling oil prices and failure to make progress toward a final nuclear deal).

**Figure 9: Domestic Demand Assumes Role of Main Growth Driver (p.p. contribution to Y/Y growth)**

![Graph showing domestic demand's role in growth](image)

*Sources: Haver Analytics and Central Bank of Iran*

**Figure 10: Services and Industry Rise in Broader-Based Recovery**

![Graph showing services and industry growth](image)

*Sources: Haver Analytics and Central Bank of Iran*
Data from the first half of FY 2014/15 also supports our claims that a broader-based recovery seemed imminent late last year. We anticipated that growth, which began in the oil sector, would eventually pass through to industrial and service sectors. Non-oil GDP registered its first y/y increase in nine quarters in Q1 at 4.0% y/y. Moving forward, growth in more labor-intensive industrial and services sectors will encourage a virtuous (albeit slow-moving) cycle of increased income, demand, and production. However, oil production will be a drag on growth in the near-term.

Our sentiment indicator (generated using RavenPack News Analytics’ proprietary natural language processing software\textsuperscript{16}) has dipped in recent months, as negotiators failed to reach a final deal, oil prices plunged, and optimism around domestic politics has faded. The moderation of sentiment supports the view that consumers and investors alike may exercise somewhat more restraint in the coming fiscal year (relative to 2014/15).

\textbf{Figure 11: Sentiment Dragged Down by Nuclear Negotiations and Fading Political Optimism}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure11.png}
\caption{Sentiment Dragged Down by Nuclear Negotiations and Fading Political Optimism}
\end{figure}

\textit{Sources: RavenPack News Analytics and Roubini Global Economics}

\textsuperscript{16} Our sanctions sentiment indicator tracks the balance of positive and negative news over a 90-day period. For more detail, see our previous publication: Paul Domjan & Mark Dubowitz, “New Sentiment Indicator Shows Positive Impact of Sanctions Relief on Iran’s Economy,” \textit{FDD Iran Sanctions Analysis}, May 15, 2014. (http://defenddemocracy.org/content/uploads/documents/Final_Sentiment_Report.pdf)
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FDD focuses its efforts where opinions are formed and decisions are made, providing cutting-edge research, investigative journalism and public education - transforming ideas into action and policy.

FDD holds events throughout the year, including the Leading Thinkers series, briefings on Capitol Hill, expert roundtables for public officials, diplomats and military officers, book releases, and panel discussions and debates within the policy community.

Roubini Global Economics (RGE) is the independent, global macroeconomic strategy research firm built by world-renowned economist Nouriel Roubini.

Roubini research combines expert insight with systematic analysis to translate economic, market and policy signals into actionable intelligence for a wide range of financial, corporate and policy professionals. This holistic approach uncovers opportunities and risks before they come to the attention of markets, helping clients arrive at better decisions in a timelier manner.

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