

IRAN'S ECONOMY: OUT OF THE RED, SLOWLY GROWING

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With the November 24 deadline looming for the Iran nuclear negotiations in Vienna, we reassess the state of the Iranian economy and its near-term outlook in light of recent data, with particular attention to the value of previous sanctions relief.¹

Bottom line: Iranian GDP data met our expectation that the economy bottomed out in the 2013/14 fiscal year (FY) and is in the midst of a moderate recovery.² Inflation has more than halved to 14.7% in August, as a result of the de-escalation of sanctions and better fiscal and monetary policy by the Rouhani government, which benefited from less economic pressure. Despite weaker oil prices, the average pace of growth should accelerate through FY 2014/15, as recovery in the industrial sector and labor markets slowly translates into stronger domestic demand. However, the economy should not be considered healthy. Iran's production will remain below potential, constrained by the need for structural reform.

Risks to our view/Future outlook: We see upside risks to our growth forecast of 2.5% in FY 2014/15. Moreover, continued uncertainty over nuclear negotiations will keep domestic and international investors on the sidelines in the coming quarters, as long-term growth depends heavily on the sanctions trajectory.

KEY TAKEAWAYS:

- **Recent Iranian data confirms the economy has begun to grow.** The energy and, to a lesser extent, the industrial sector outperformed in late 2013/14, contributing the bulk of economic growth. However the labor-intensive service sector lagged, continuing to shrink, and deferring the benefits of sanctions relief felt by average Iranian households.
- **The Iranian government's policies constrained economic growth in the wake of sanctions relief, but also stabilized inflation and increased economic resilience.** Following the election of President Hassan Rouhani and start of nuclear negotiations, abating external pressures allowed the new administration

1. This analysis is co-authored by the Foundation for Defense of Democracies (FDD) and Roubini Global Economics (RGE). FDD is a non-profit, non-partisan, policy institute whose experts have written extensively on U.S. policy toward Iran. As an independent economics research firm, RGE does not take a view on what policy the U.S. should adopt with respect to Iran. Both organizations believe that a better understanding of Iran's economic state can help inform policy choices.

2. Paul Domjan, Jennifer Hsieh, Rachel Ziemba, & Mark Dubowitz, "Sanctions Relief: What Did Iran Get?" *Roubini Global Economics & Foundation for Defense of Democracies*, July 18, 2014. (<http://defenddemocracy.org/content/uploads/general/RoubiniFDDReport.pdf>)

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to focus on macroeconomic stabilization (a rarely cited benefit of sanctions relief). Tighter fiscal and monetary policies limited consumption and credit growth, but also reduced inflation, tempered asset bubbles, and built resilience against future shocks. Absent this policy, economic performance in the second half of FY 2013/14 would have been stronger.

- **As the drag from these restrictive domestic policies lessens and the secondary benefits of sanctions accumulate, the average pace of growth will accelerate as domestic demand gains traction.** The full economic benefits of sanctions relief (including reduced transactions costs that facilitate imports) are only beginning to emerge. We expect that they will be more substantial in the second six-month period from July to December than the first six-month period, from the implementation of the Joint Plan of Action (JPOA) in January to June 2014.

FIGURE 1: THE ECONOMY BOTTOMED OUT IN 2013/14 AND WILL POST MODERATE GROWTH THIS YEAR

		2011/12	2012/13	2013/14	2014/15 (f)
		Aggregate			
Real GDP	Growth (%)	3.7%	-6.6%	-1.9%	2.5%
Real Total Consumption	Growth (%)	2.9%	-2.6%	-0.6%	2.0%
CPI Inflation	Average	21.5%	30.5%	34.7%	15.1%
	End of Period	20.5%	41.2%	19.7%	17.2%
Exchange Rate (IRR/USD, eop)	Official	12,260	12,260	25,444	27,900 - 28,300
	Unofficial/Black Market	19,050	34,325	30,250	33,100 - 34,100
Reserves (bil. USD, eop)	Total	100	90	105	120-125
	Unrestricted	N/A	N/A	25	25-30
		Per Capita			
(2011=100)	Real GDP	100.0	92.2	89.2	90.3
	Total	100.0	96.2	94.3	94.9
	Consumption				

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

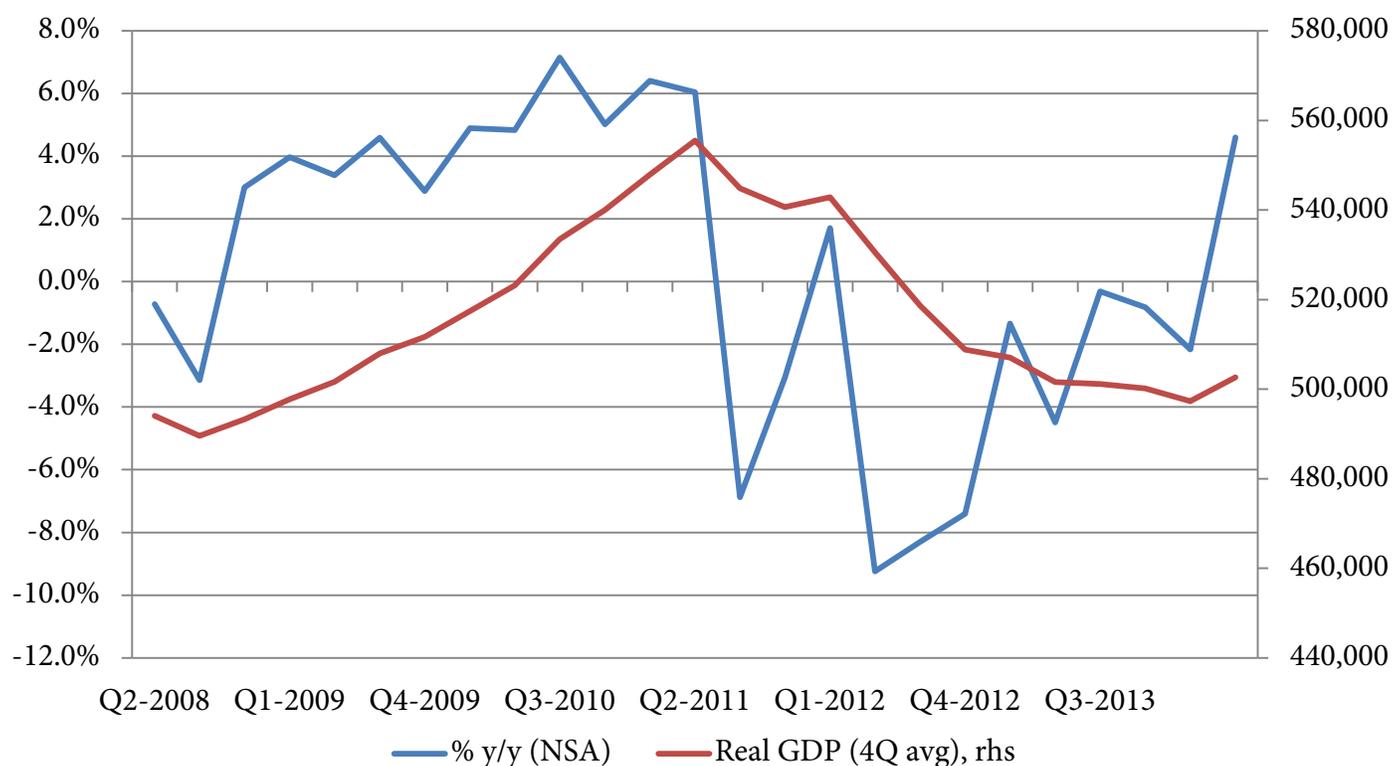
- **The recent drop in global oil prices is more meaningful for Iran's longer-term prospects than its near-term growth or financial stability.** Sanctions insulate the Iranian economy by distorting the normal relationship between oil prices, government spending, and asset prices. The current sanctions regime dictates that oil revenue would have accrued to Iran's overseas escrow accounts, where use of the funds is restricted. Thus, falling oil revenues will translate into slower accumulation of reserves, but little change in the near-term outlook for imports, currency, or government spending. We expect only a minor dampening effect on Iranian GDP this year, via slower growth in the production of condensates. However, a long-term decline in oil prices that reflects weaker demand would devalue Iran's untapped

energy reserves and reduce its attractiveness to foreign investors, while lower revenues strain the government budget and impair long-term growth.

- **Our forecasts assume that sanctions relief remains in place through this fiscal year.** If negotiations are extended for six months from the November 24 deadline, Iran will gain access to an additional \$4-5 billion in reserves. If the terms of a JPOA extension remain consistent with the prior agreement, the current average monthly release of oil revenues will amount to \$700 million per month. We expect a gradual rise in oil exports (including condensates) to 1.5 million barrels per day (mbpd) by year end and 1.6 mbpd by the end of FY 2014/15. The rollover of sanctions relief and stronger economic growth will foster a slight improvement in confidence, but will not spur foreign investment.
- **Only a collapse in the talks and quick re-imposition of sanctions would weaken growth substantially below the 2.5% y/y pace we project in FY 2014/15.** Indeed the balance of risks is tilted toward greater expansion as the recovery builds momentum and recent data continues to surprise on the upside. However, economic performance in FY 2015/16 will depend heavily on the outcome of negotiations. While our baseline points to stronger growth, the deterioration of negotiations and a tightening of restrictions could lead to an economic slowdown next year.

RECOVERY IS UNDERWAY

FIGURE 2: Y/Y GROWTH RETURNS TO POSITIVE TERRITORY

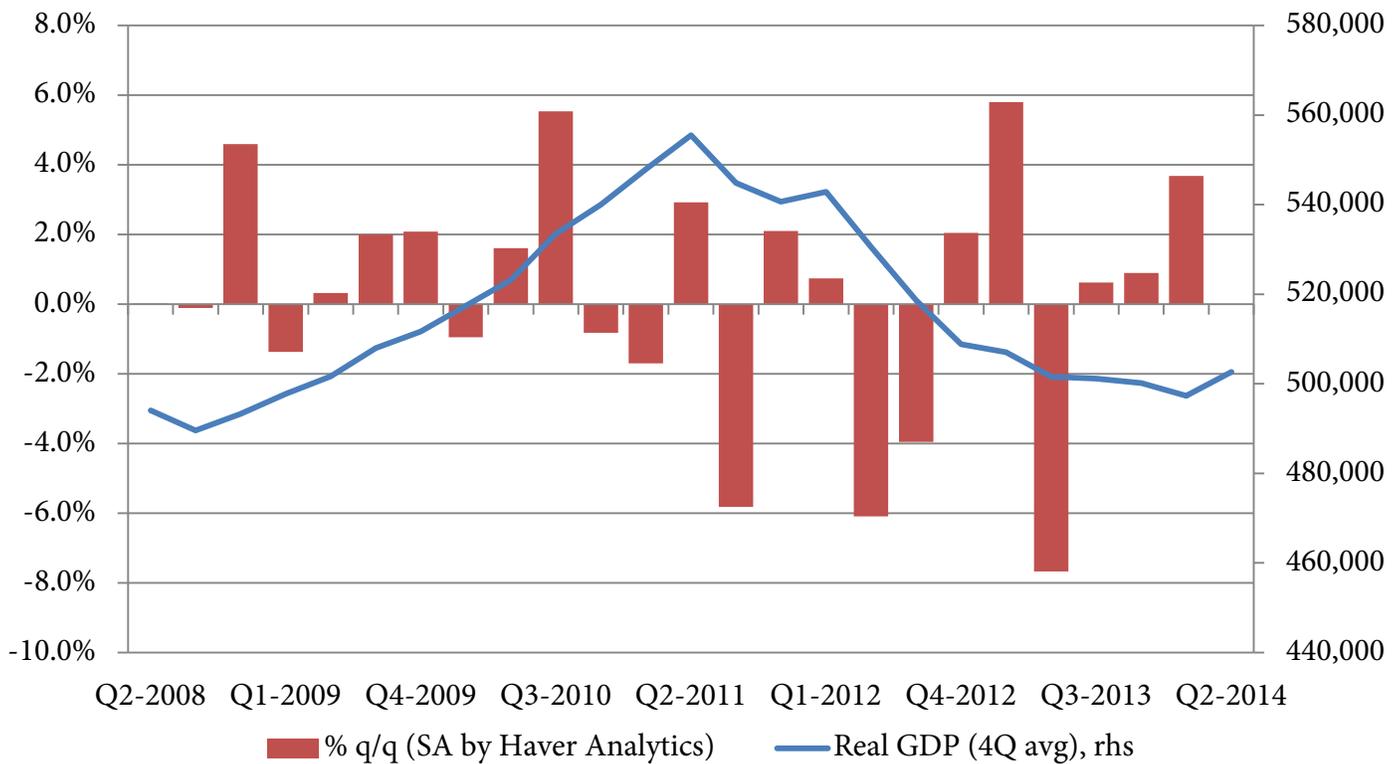


Source: Haver Analytics, Roubini Global Economics

Note: GDP for Q2 2014 (March 21- June 21), or summer 1393 (Q1 FY 2014/15) is calculated from the 4.6% y/y growth rate cited by Iranian officials. Final data has not yet been released and may include statistical adjustments to previous quarters.

Revised GDP data confirmed our assessment that the Iranian economy stabilized by late 2013 and is in the midst of a modest recovery. Real output contracted 1.9% in FY 2013/14 (ending March 20, 2014), after falling 6.6% in the previous year (2012/13). The mid-2013 election of President Hassan Rouhani, the de-escalation of sanctions pressure, and the subsequent JPOA agreement had several immediate positive effects. Stronger investor and consumer sentiment helped stabilize the beleaguered Iranian currency and paved the way for a modest expansion through the latter half of the fiscal year. Seasonally adjusted data calculated by Haver Analytics suggests the economy bottomed out in fiscal Q1 (ending June 21, 2013), and accelerated in each of the following three quarters.³

FIGURE 3: SEASONALLY ADJUSTED DATA REVEALS GROWTH ACCELERATION⁴



Source: Haver Analytics, Roubini Global Economics

Based on press reports, Iranian officials project growth of +4.6% y/y in Q2 2014 (Q1 of FY 2014/15).⁵ If accurate, this represents a significant improvement from the 2.2% y/y decline recorded in the previous quarter. Granted, much of the acceleration in y/y growth stems, mechanically, from its comparison to a particularly weak quarter in the previous year (the worst of the crisis). **Thus, while the y/y pace of growth may fluctuate substantially, the benefits of sanctions relief will nevertheless continue to accumulate, putting full year growth around 2.5%.**

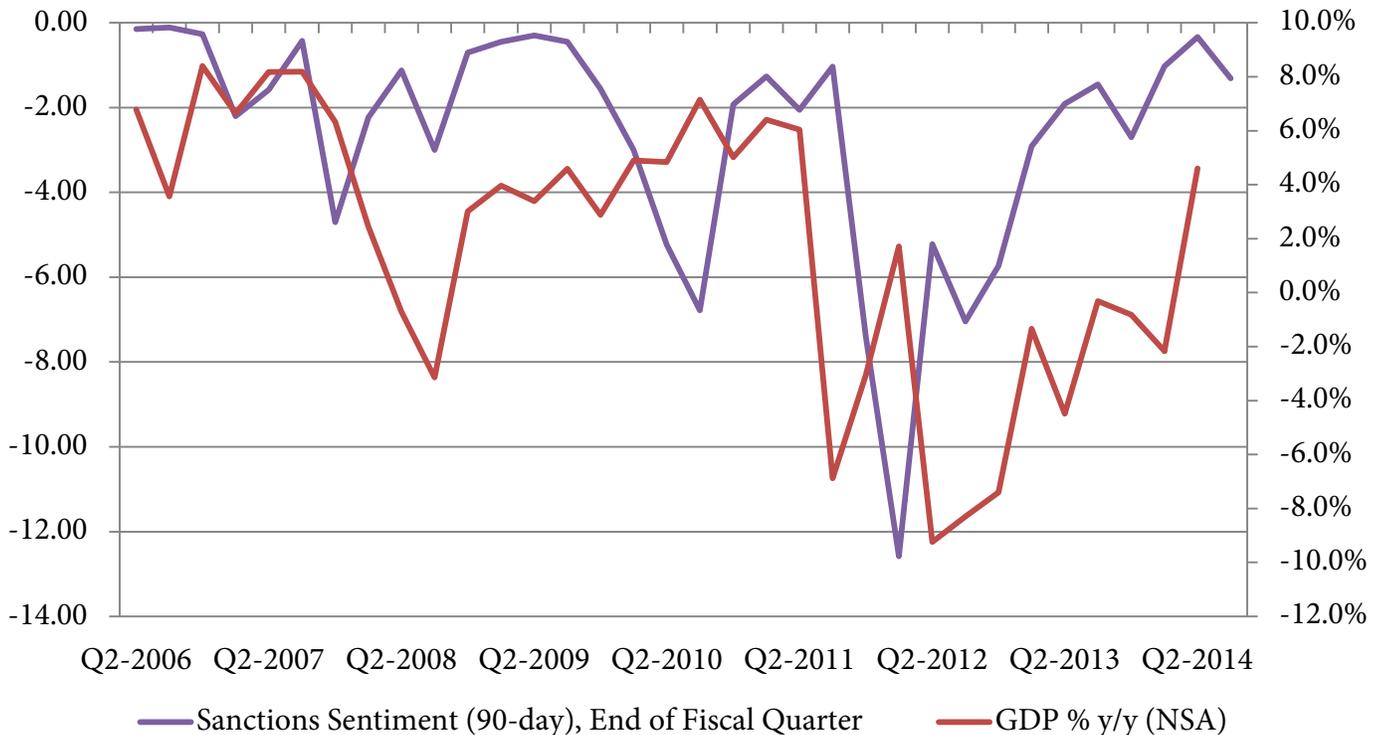
3. Data was adjusted using X-12 Arima over the series of final output data (available through FY 2013/14). It is, however, subject to revision following the release of additional data.

4. Official and seasonally adjusted data is not yet available for Q2 2014 (Q1 FY 2013/14)

5. “4.6% Economic Growth Logical,” *Zawya*, October 8, 2014, (http://www.zawya.com/story/46_economic_growth_logical-ZA-WYA20141009062244) & “Iran’s Economic Growth Likely to Slow Down Again,” *Azernews*, October 17, 2014. (<http://www.azernews.az/region/72086.html>)

Improving sentiment reinforces this view. Using RavenPack News Analytics’ proprietary natural language processing software, our sanctions sentiment indicator tracks the balance of positive and negative news over a 90-day period.⁶ The indicator captures the turning points and trajectory of economic growth much more quickly. This proves particularly useful in tracking recent economic performance given the delay in the reporting of GDP data. Stronger sentiment corroborates the substantial economic improvement touted by Iranian officials and suggests that the average pace of growth will continue to improve over the fiscal year.

FIGURE 4: SANCTIONS SENTIMENT SIGNALS IMPROVING CONFIDENCE AND FORESHADOWS STRONGER GROWTH⁷



Source: Haver Analytics, Roubini Global Economics

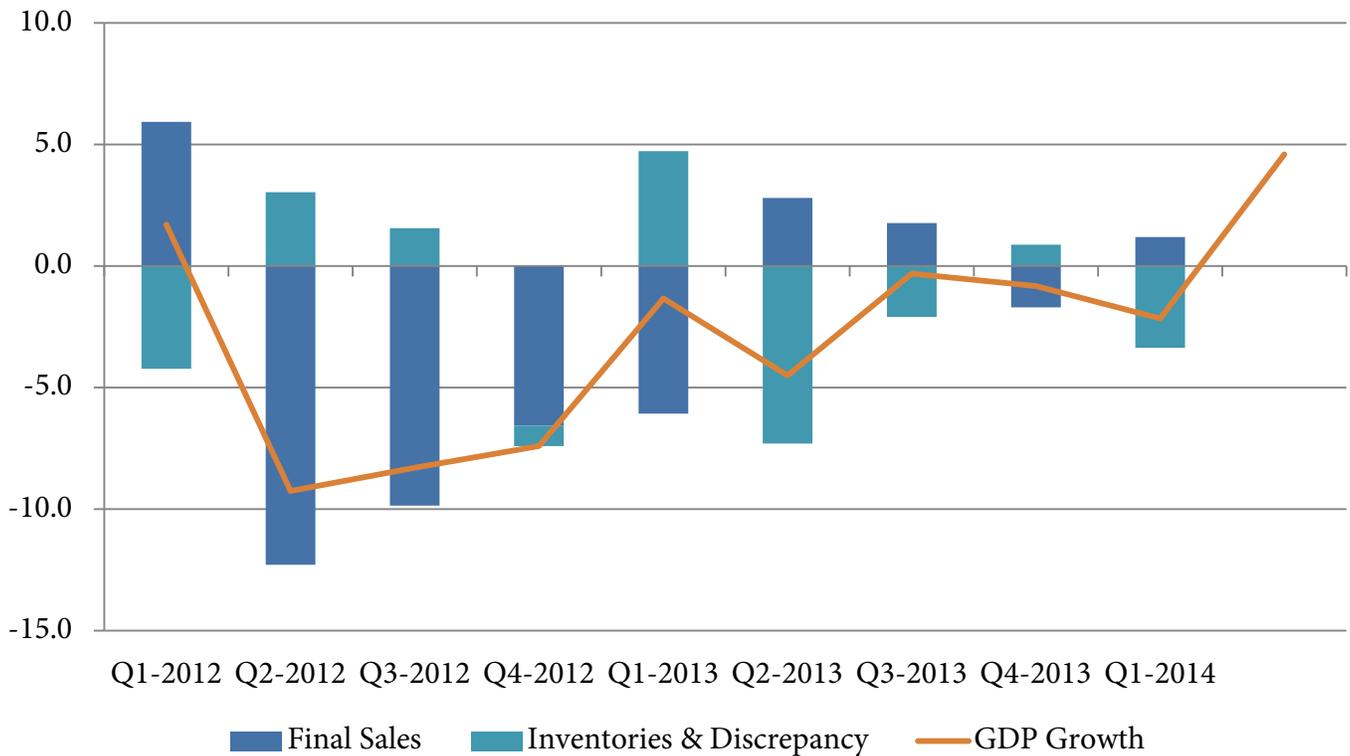
Improvements in final sales (which combine consumption, fixed investment, and net exports) also build the case for a recovery that began last year and will yield positive growth this year. Final sales posted positive y/y growth in three of four quarters last year while the depletion of inventories shaved a massive 2.9pp from full-year GDP growth of -1.9%.⁸ Growth will turn positive this year as confidence builds, and inventories constitute less of a drag.

6. For more detail, see our previous publication: Paul Domjan and Mark Dubowitz, “New Sentiment Indicator Shows Positive Impact of Sanctions Relief on Iran’s Economy,” FDD Iran Sanctions Analysis, May 15, 2014. (<http://defenddemocracy.org/media-hit/dubowitz-mark-new-sentiment-indicator-shows-positive-impact-of-sanctions-relief-on-irans/#sthash.AEV3FK45.dpuf>)

7. The sanctions sentiment indicator below has been recalculated using the most recent version of the RavenPack News Analytics database, released after our last report. The revised indicator benefits from a larger set of articles and tracks growth more closely than the previous version.

8. The CBI no longer releases data on inventories. The figures cited are imputed using total production less total demand, and represents the change in inventories plus net acquisition of assets and statistical discrepancy.

FIGURE 5: GROWING FINAL SALES HINT AT A STRONGER RECOVERY



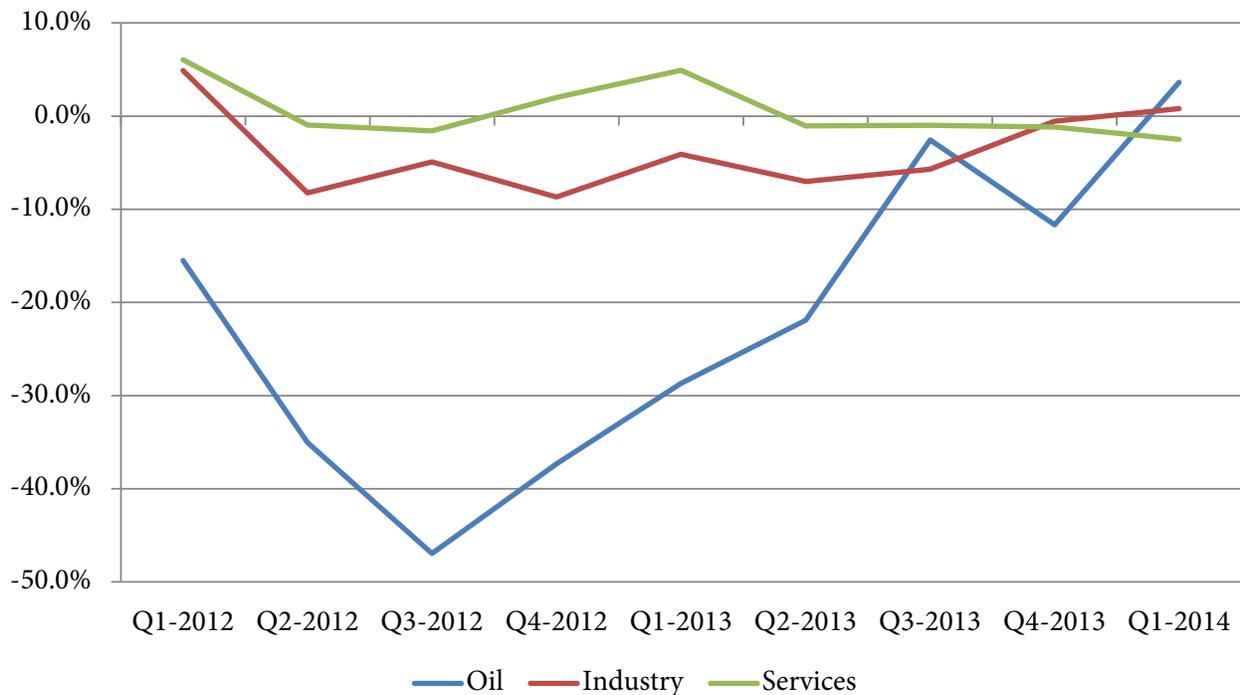
Source: Haver Analytics, Roubini Global Economics

DOMESTIC DEMAND LAGS, BUT A BROADER-BASED RECOVERY IS IMMINENT

Following implementation of the JPOA in early 2014, economic gains have been concentrated in sanctions-related sectors, including energy and automotive, which have rebounded after experiencing the sharpest declines. However the services sector, most linked to consumption and Iran’s ample small business sector, has yet to see improvement. Services continued to shrink on an annual basis through FY 2013/14, although this is partially attributable to the reversal of higher spending seen in the run-up to 2013 elections.

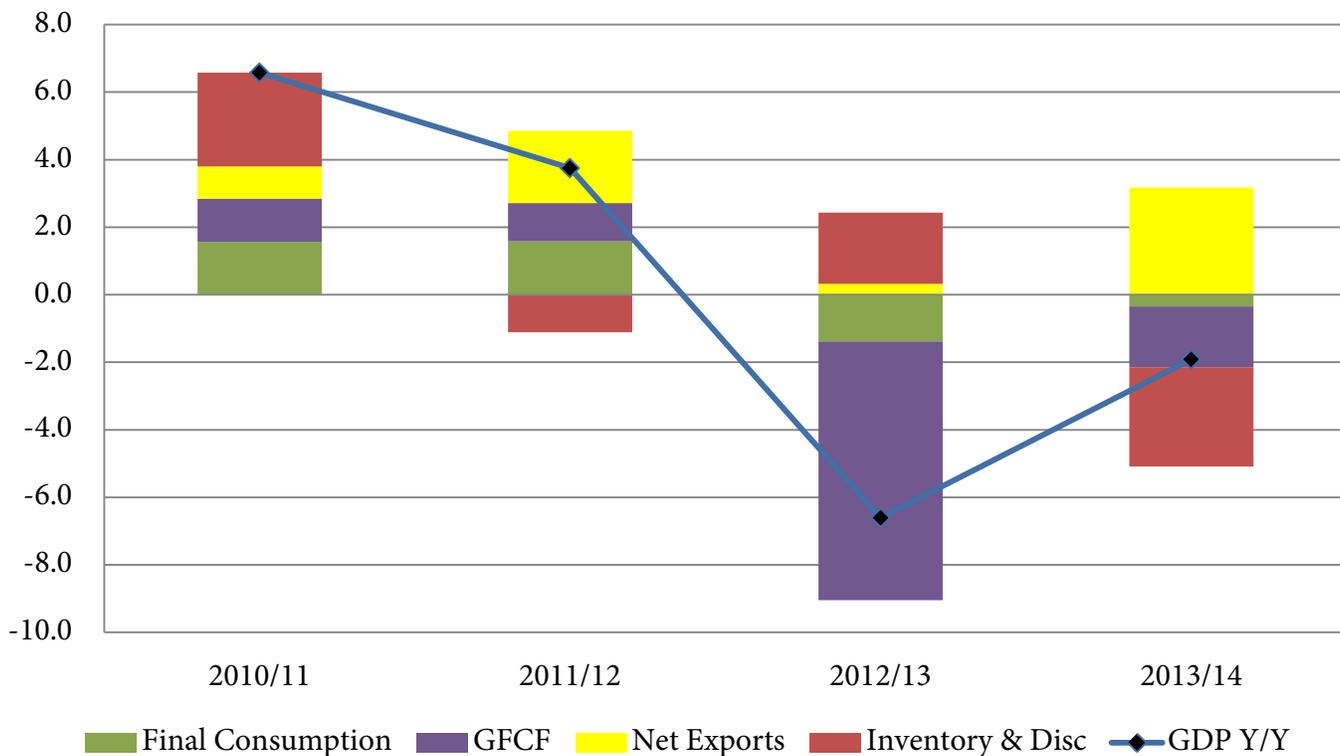
Import restrictions, import substitution, and a decidedly weak currency have boosted Iran’s net exports, which have risen in recent years despite the cap on oil sales. Conversely, domestic demand (consumption and investment) has been a drag on growth, as fixed investment plunged and falling revenues curtailed public spending. Total consumption declined 3.6% in the two years ending Q1 2014, at a time when the population has grown approximately 2.7%. This corroborates anecdotal reports that the average Iranian household saw little evidence of economic improvement in the months immediately following implementation of the JPOA.

FIGURE 6: OIL SECTOR WAS THE MAIN SOURCE OF GROWTH IMPROVEMENT (REAL GROWTH % Y/Y, NSA)



Source: Haver Analytics, Roubini Global Economics

FIGURE 7: DOMESTIC DEMAND REMAINS A DRAG ON GROWTH (P.P. CONTRIBUTION TO Y/Y GROWTH)



Source: Haver Analytics, Roubini Global Economics

Nevertheless, the Iranian economy should continue to build momentum in coming quarters, owing to a smaller drag after much-needed policy adjustments and the cumulative benefits from sanctions relief. Even without additional measures, the positive effects of the JPOA should be greater in the second six months relative to the first, owing to 1) implementation delays which limited early gains and 2) slower-moving second-order effects, including the slow pass-through from increased confidence to stronger domestic demand and improved labor markets.

Recent trends and early data from the auto sector support this view. The automotive sector, Iran's second largest sector, employed roughly 4% of the population in 2011 and accounted for 10% of GDP. Production fell by over half in the last two years, to 700,000 units in FY 2013/14. The sector saw few immediate gains following the JPOA agreement, owing to the slow process of restarting production and a large run-up of inventories in FY 2012/13. However, access to the more favorable official exchange rate (beginning in April 2014), rising confidence, and the suspension of key import restrictions have facilitated a robust rebound in recent months. Early reports indicate that production grew over 70% in the first quarter of the fiscal year, with some projecting full-year output of 1.3 million units.

The ongoing auto sector recovery also appears to coincide with a pick-up in Iran's labor market, where unemployment is reported to have fallen to 9.5% in summer 2014, from 12.4% two years ago. However, the sizable decline in unemployment may not translate into stronger household earnings. The 0.9pp decline in unemployment over the last year is mostly attributable to a decline in labor force participation (down 1.9pp to 37.2%) while employment has actually fallen 3.1% y/y. Still, it's worth noting that Iran's semi-Soviet-style labor market places a strong focus on full employment. As such, falling production typically spurs reductions in hours worked rather than actual job losses. People need only work one hour to be counted among the employed.⁹ Thus employment fluctuates little relative to other economies, even in severe recessions. In short, falling unemployment doesn't necessarily correlate with rising real wages, and falling employment doesn't necessarily imply lower aggregate earnings.

Nevertheless, recovery in auto sector production, along with a more stable inflationary environment should support stronger consumption in FY 2014/15.

FALLING OIL PRICES PRESENT A LONG-TERM RISK TO IRAN'S ECONOMY BUT HAVE LIMITED SHORT-TERM IMPACT

More recently, the sharp decline in oil prices has drawn attention to the fiscal standing of OPEC members and the potent effects of a sharp decline of oil revenues. Iran remains one of the more fiscally vulnerable OPEC members. Its 2014 spending required an oil price of over \$110-120 per barrel as the volumes of exports remained constrained. Iran will likely not have much trouble meeting spending needs this year. If needed, the government will rely on borrowing from local banks and cuts to public spending.

Weaker oil prices will likely have a limited impact on Iran's near-term growth outlook. Like its OPEC peers, Iran will likely try to preserve its market share, rather than cutting production to stabilize prices. However, lower demand does reduce incentive for Iran and its trading partners to circumvent sanctions and increase exports. This leads us to lower our fiscal year-end estimate, from 1.9 mbpd (including condensates) to 1.6 mbpd. Iran's oil output volume already stalled after Q2 2014, as the Chinese tempered their purchases after restocking their strategic reserves. We now believe there will be little further increase in volume in the next few months, as Iranian authorities remain reluctant to apply significant price discounts.

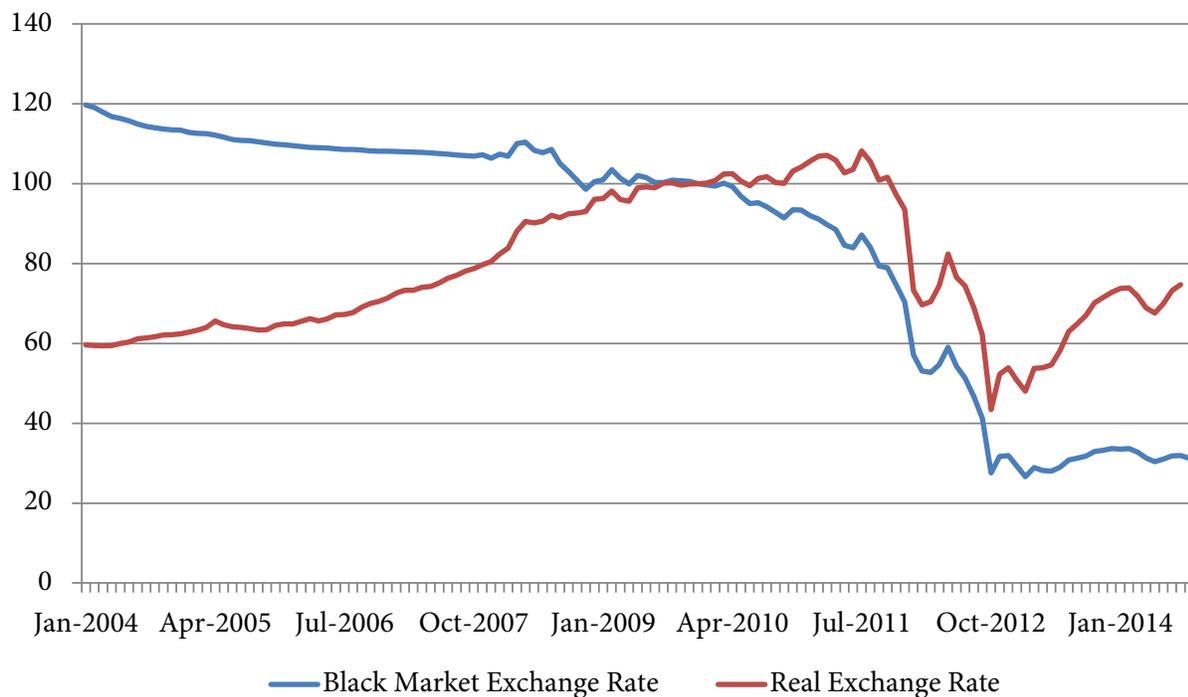
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9. Consistent with the International Labour Organization (ILO) global definition.

However, lower oil prices are not necessarily relevant to near-term government budget considerations. Due to sanctions, forgone oil revenues would have otherwise accrued to Iran’s escrow accounts, where oil revenues are accumulating abroad, and where the use of funds is restricted to limited bilateral trade with select countries and humanitarian channels. At \$80-90 per barrel, Iran will accumulate reserves much more slowly in semi-restricted overseas escrow accounts, but this would only have a meaningful impact on the economy when Iran is able to access those assets in the context of a final deal or a more substantial partial deal.

Still, a substantial, long-term decline in oil prices could put a strain on public finances and increase pressure on Iranian policymakers to arrive at a final deal. A steep and lasting drop in oil prices would put the government budget on an unsustainable path. Lost revenue would eventually have to be compensated by a rebalancing of the structural deficit, not to mention a decline in public investment. This would increase pressure on Iranian negotiators, as access to foreign capital and lower transactions costs for the non-oil sector become more crucial in the context of lower oil income – in order to bridge domestic shortfalls in fixed investment and external financing.

THE RIAL SHOULD WEAKEN ONLY SLIGHTLY ON RESERVE LIMITATIONS

FIGURE 8: RIAL APPRECIATES IN REAL TERMS AGAINST THE USD¹⁰ (MONTHLY AVG, DEC 2009 = 100)



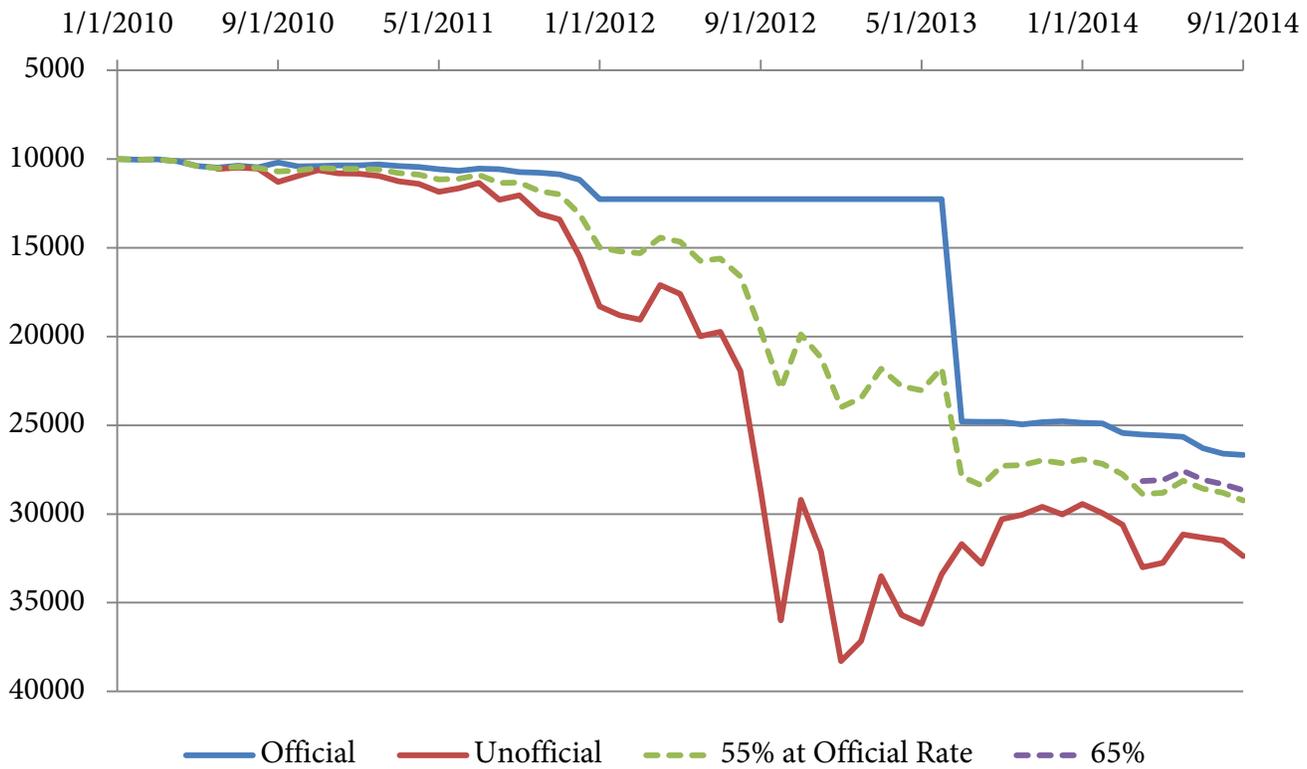
Source: Haver Analytics, Roubini Global Economics

Both black market and official exchange rates depreciated roughly 6-7% over the last year against the USD (as of September 30). However, this figure obscures improvement on other fronts. Depreciation of the black market

10. This does not account for differences in the price baskets of consumer goods. The average black market exchange rate appreciated 2.1% on an annual basis as of August 2014 but Iranian prices rose 14.7% y/y versus 1.7% in the U.S.– implying that the real exchange rate strengthened by roughly 15%.

rate over the last year has been quite modest (relative to its historical average of 14% annually¹¹), and did not fully compensate for the inflation differential over the same period of time. Furthermore, more transactions now utilize the (stronger) official exchange rate, particularly since the auto sector gained access to the official rate as of April 24. This improves purchasing power.

FIGURE 9: MORE “OFFICIAL” RATE TRANSACTIONS SUPPORT AVERAGE IMPORT EXCHANGE RATE¹²



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

Imports from China rose significantly in Q3 2014, reducing Iran’s sizable trade surplus. This reflects one of the more meaningful effects of the JPOA – namely improved access to imports, particularly as select financing costs fell after the suspension of sanctions on select transactions. At the same time, Iran still maintains large surpluses with Turkey and India, a sign of its continuing struggle to find sufficient non-sanctioned goods to buy from those countries. In all, Iran’s accrued surpluses in these escrow accounts have grown by an estimated \$15 billion in the last 12 months, taking total reserves to about \$120 billion. We expect total reserves to rise to \$120-125 billion by the end of FY 2014/15, barring a sharper decline in oil prices.

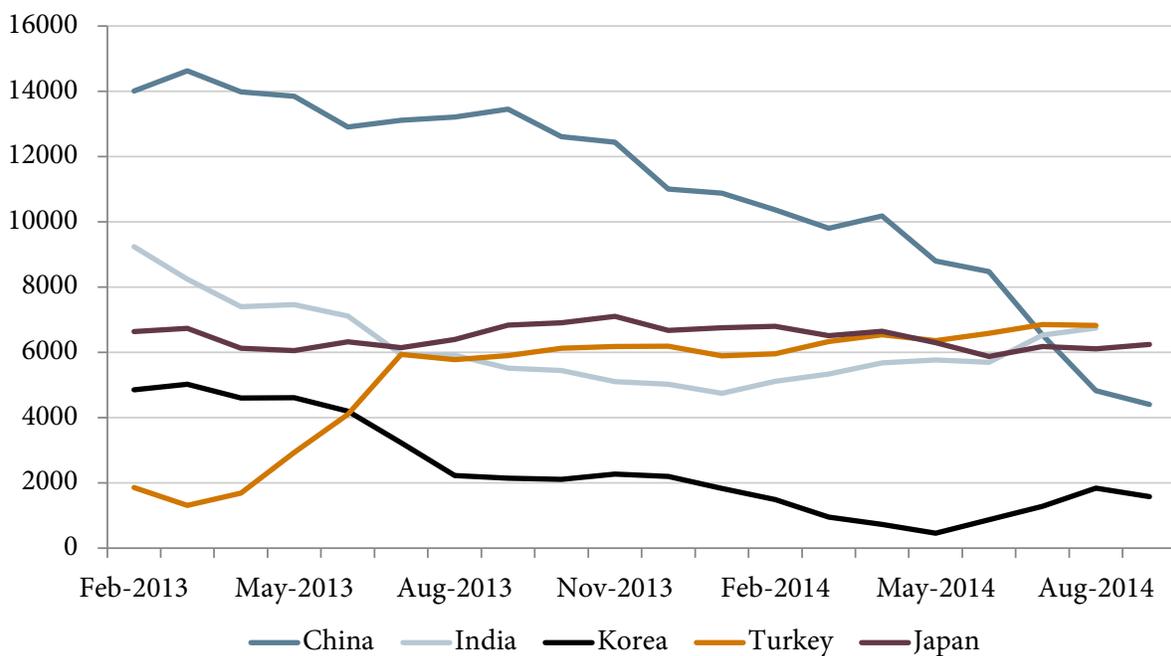
Historically, inflation differentials, oil prices, and oil demand have typically driven changes in the exchange rate. Iran’s weaker terms of trade will likely provide less fundamental support for the exchange rate in the medium- to long-term. However, in the near-term, the sanctions regime has distorted the normal mechanisms of exchange rate

11. Compound Annual Growth Rate (CAGR) from 1980-2010.

12. The dotted lines show the path of the “average” exchange rate under different proportions of official rate transactions. If 55% of transactions occurred at the official rate last year, rising to 65% this in the last six months (meaning roughly 5% of total transactions switched over from the black market to the official rate), the average exchange rate has weakened less than 5% over the course of the year.

adjustment. This was most recently demonstrated by the rial's near-total indifference to plummeting oil prices this fall. For now, the import coverage ratio (accessible reserves divided by imports), sentiment surrounding sanctions negotiations, and the government's policy toward unifying exchange rates are perhaps the more salient factors. Looking forward, Iran is set to gain access to an additional \$4-5 billion (if the JPOA is extended for six months beyond November 24), but rising imports and demand for foreign exchange will keep pressure on the rial. Higher utilization of the (preferential) official exchange rate will edge both the official and black-market rate higher, although the average rate will reflect a more moderate depreciation. A negotiation breakthrough or significantly greater access to reserves would spark a stronger appreciation of the rial, thus volatility around the negotiation period should be expected. We expect the rial exchange rate to stabilize at roughly 4-5% weaker than the current level by the end of FY 2014/15.

FIGURE 10: NET TRADE WITH KEY TRADING PARTNERS, ROLLING 12 MONTH SUMS

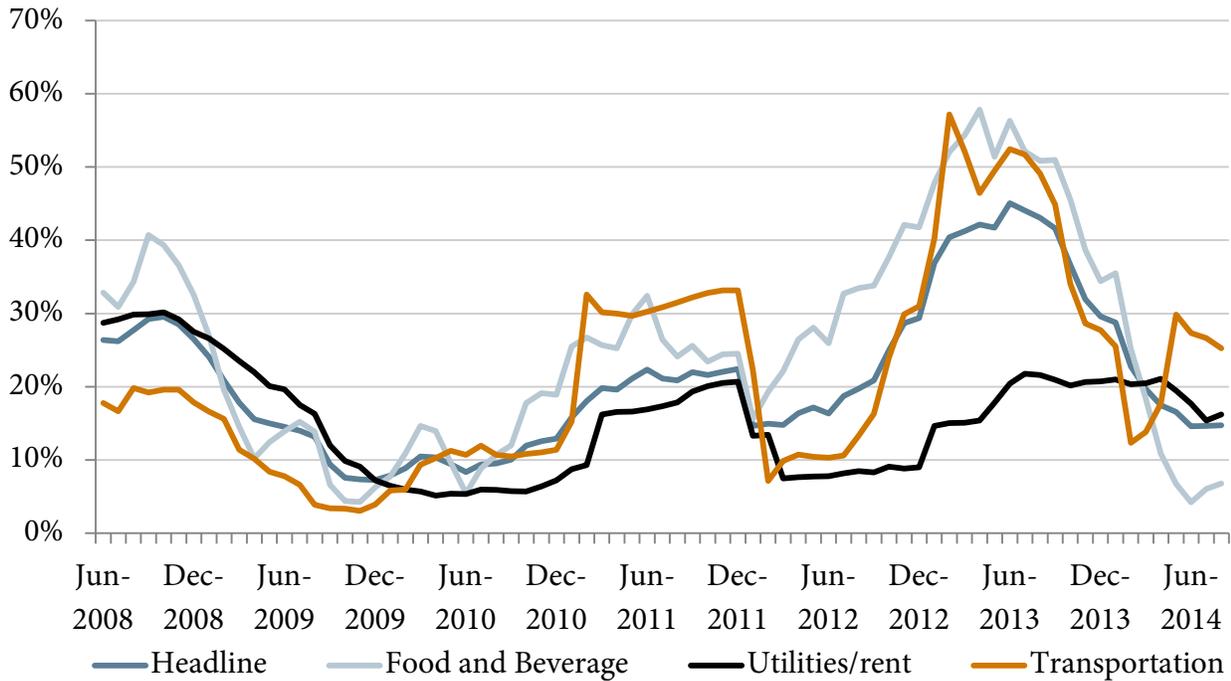


Source: Haver Analytics (National Statistics Agencies), Roubini Global Economics

INFLATION HAS FALLEN DRAMATICALLY

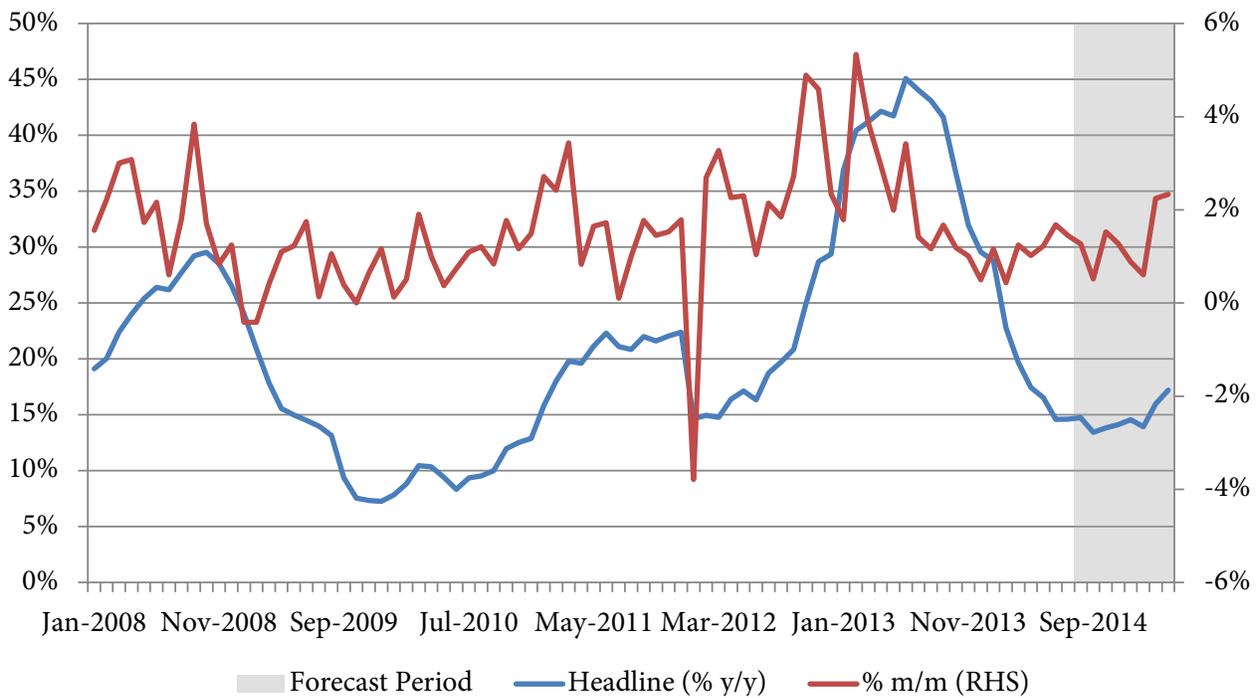
The path of inflation constitutes perhaps the most significant economic improvement over the last year. Price growth stabilized around 14.7% between June and August, from roughly 43% in the previous year. The decline reflects stabilization and appreciation of the rial, along with a more prudent monetary and fiscal policy facilitated by an easing of sanctions pressure. The successful anchoring of inflation expectations below 20% will reduce the distortionary effects of runaway inflation, which previously prompted real asset hoarding and a sharp decline in fixed investment. Y/Y inflation is expected to tick upward in the coming months, as the disinflationary effect of last year's modest currency rebound fade and gas prices increasingly pass through to overall prices. Inflation should average just over 15% in FY 2014/15.

FIGURE 11: FOOD AND HOUSING COSTS HAVE EASED ALONG WITH OVERALL PRICE PRESSURE.



Source: Haver Analytics

FIGURE 12: Y/Y INFLATION WILL EDGE UPWARD BUT REMAIN BELOW 20%



Source: Haver Analytics, Roubini Global Economics

TWO ADDITIONAL DOWNSIDE RISKS TO OUR FORECAST

- **New Sanctions:** Significant failure in the nuclear talks could reverse some of the recent growth trends and prompt a return to recession in the next fiscal year as oil output falls, sentiment suffers, and the government has little space to provide stimulus. Given the timeline of negotiations, we doubt the outcome will have meaningful effects on 2014/15 growth, as the bulk of the year will already have elapsed. A very negative result, however, could have an immediate negative impact on sentiment and would dampen growth early next year. Even then, return to a tighter sanctions environment would likely bring about a more moderate recession than their original imposition in 2012. The asymmetric outcome of sanctions re-imposition partially reflects adjustment the economy has already weathered. Furthermore, the coalition to impose sanctions may be somewhat weaker given the risk of side-deals between Russia and Iran and other loopholes.
- **Investment and Constraints on Credit Growth:** Iranian businesses remain hesitant to invest, notwithstanding the stabilization of the economy. This reticence, particularly on the part of small business, reflects both uncertainty about the trajectory of the nuclear negotiations and the future of sanctions, as well as tight domestic credit and competition from cheap Asian imports. Anecdotal evidence suggests Iranian businesses still struggle to access credit and continue to use different barter arrangements, rather than turning to banks. Growth could be slightly weaker than projected should these trends persist.



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FDD transforms ideas into action and policy by focusing its efforts where opinions are formed and decisions are made. 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.

RGE provides a window to the dynamics and developments underpinning the global economy, highlighting signals that can impact investment decisions.