INSS Insight No. 1005, January 4, 2018

Iran's Economic Situation Two Years after the Removal of the Sanctions

Nizan Feldman and Sima Shine

The Macroeconomic Picture and Immediate Internal Challenges

Iran's renewed engagement with companies and markets that were denied access by the international sanctions have generated a significantly favorable economic shock, which is reflected in most of the country's economic indices. While the Iranian GDP in 2015 declined by 1.6 percent, in 2016 the economy grew by about 12.5 percent (the annual data relate to the Iranian fiscal year, which begins on March 21). Exports of goods and services rose by more than 25 percent, which led to a rise of about 80 percent in surplus in the current account. A surge of about 66 percent in the inflow of foreign direct investments was also recorded in 2016.

Iran's return to the global energy economy is the main factor behind the impressive growth. Oil production rose by dozens of percentage points in 2016 and the real oil GDP growth rate rose by about 62 percent. The improvement in the energy sector also continued in 2017, and in recent months, global oil production has stabilized at about 3.8 million barrels per day, of which about 2.5 million barrels are earmarked for exports – more than double the exports of over 1 million barrels per day in 2014.

On the other hand, non-oil GDP growth was only about 3.3 percent in 2016. Although at issue is a record high for the past five years, this is a relatively moderate growth rate, considering that the point of reference is the low GDP of 2015. The data for 2017 show that additional recovery in economic activity unrelated to the energy sector has begun, and the International Monetary Fund expects the aggregate growth to reach a reasonable rate of more than 4 percent in 2017. However, the growth has not yet translated into a significant reversal in the unemployment rate, which actually rose slightly in 2016 to 12.4 percent.

The Iranian government is aware of the serious problem caused by unemployment - reflected in the current public demonstrations - and therefore the government has emphasized its determination to reduce the unemployment rate and increase productivity through a policy that will increase local investments in various sectors. However, there has in fact been a decline in the total local investments over the last two years, and this year the government expenditures designated for development programs were slashed. The difficulty in taking action now to increase local investments derives from the concerns about increasing the deficit and eroding the Rouhani government's achievements in lowering inflation.

In 2016, inflation reached about 9 percent, and it is expected to reach about 9.9 percent in 2017 - a sharp decline from the record high of 34.7 percent recorded in 2013. A significant portion of the inflation derives from the policy implemented by the Ahmadinejad regime, which was characterized by higher government expenditures financed with a loan from the central bank. In order to balance the budget and stop the inflation, President Rouhani implemented a policy of restraint, which led to a decline in government investments. The high interest rate set by the central bank in an effort to counter the inflation also adversely affects the volume of local investments, and hinders attempts to expand the turnovers in the Iranian stock exchange. Notwithstanding the lower inflation rate, the central bank is still concerned that lowering the interest rate too rapidly might trigger another inflationary surge and an additional depreciation of the local currency, which continues the decline that began after the 2016 United States presidential elections.

The tension between the need to increase expenditures earmarked for development and the creation of jobs on the one hand, and the concern about discontinuing the policy of restraint too quickly on the other hand, led the Iranian government to include items in its 2018 budget proposal that are intended to increase government revenues from various taxes. The government also strives to reduce significantly the number of those entitled to the direct transfer payments that were instituted in 2010 (in an attempt to compensate citizens for the cutbacks on subsidies of food and energy products). These measures are met with harsh public criticism, however, which in turn constricts the political maneuvering room that the increase of budgetary sources usually provides.

The state of the banking system is one of the most urgent challenges facing the economic leadership. The allotment of credit to unfeasible projects led by previous governments has left the banks with balance sheets attesting to a high volume of non-performing loans. According to the assessment of the International Monetary Fund, the average ratio of non-performing loans in the banking system reaches about 12 percent, with a number of key financial institutions recording a far higher ratio of such non-performing loans in their balance sheets.

The banks' urgent need for immediate sources of funds prompts the local financial system to compete for deposits, and the banks are trying to entice depositors with very high interest rates. In an attempt to combat this phenomenon, the central bank instituted a directive recently that puts a ceiling on the interest rate that banks can offer on deposits. However, similar to most sectors in the Iranian economy, the banking sector is also subject to the high involvement of the Revolutionary Guard Corps, so there is doubt about the degree of compliance with the central bank's directives on the part of at least some of the financial institutions. The severe repercussions that the toxic assets are causing in the banks' balance sheets will presumably require the government to implement a significant course of action soon to recapitalize banks, which can be expected to incur material budgetary costs.

Foreign Direct Investments and International Trade

Given the difficulties increasing local investments, and due to the poor condition of the infrastructures of most of the manufacturing sector as well as those in the energy sector, Iran's need for direct foreign investments has become even more urgent. Iran hopes to succeed in attracting direct foreign investments over the next five years of an annual $15 billion, in addition to investments at an annual volume of $20 billion that will be injected as joint initiatives between Iranian and foreign companies. At issue is a very ambitious target whose materialization depends on key economic factors and the regime's ability to lead reforms, which given political constraints, is a highly tenuous possibility.

Following the nuclear agreement and the removal of the sanctions, important deals were closed and dozens of MOUs were signed with multinational companies, and their fulfillment has strategic implications for Iran's oil, gas, refinery, transportation, infrastructure, and manufacturing sectors. However, the uncertainty about US policy and the concern about the re-imposition of sanctions following President Trump's threats to cancel their continued suspension deter companies and financial institutions. These concerns pose financing constraints on foreign companies that are interested in investing in Iran. Although major corporations, such as the French company Total, which is supposed to lead the development of Phase 11 in the South Pars gas field, can proceed using their own equity, this is not their preferred mode of financing. The difficulty engaging with major banks also hampers Iran's attempts to expand exports of non-oil products. The renewal of the engagement with the SWIFT system significantly helped with the clearing of international payments of trade deals. Over the past year, there was also a rise in the access to correspondent banking relations with international banks and their willingness to open letters of credit. But even these engagements are not with top-ranking banks, and the number of international correspondent banks, which reached 238 early this year, is still low, compared to the 633 engagements in 2006.

In conclusion, the positive contribution that the removal of the international sanctions yielded the Iranian economy is evident in its economic activity, and the majority of the forecasts expect the Iranian economy to grow at a reasonable rate over the next two years.

However, its ability to achieve sustainable growth and prevent rapid deterioration in the macroeconomic situation requires the regime to make complex decisions, some of which are unpopular and have internal political implications. These are reflected in the new budget submitted by the government, which includes a plan to impose a steep cutback in the number of recipients of subsidies (about 20 million people) and a slash in the bread subsidy, alongside an increase of more than 30 percent in the budget allocated to the Revolutionary Guard Corps, which reflects the organization's rising expenses, due to its activities in Syria, Iraq, and Yemen. Therefore, it is not surprising that slogans voiced during the current public protests in Iran rail against the investment of resources in arenas outside of Iran.

Iran's economic problems will intensify if President Trump decides, as he threatened, to re-impose the US sanctions that were removed as a result of the nuclear agreement, or if he decides, as he intimated in recent days, to impose sanctions if the regime seriously cracks down on the protestors, and mainly, if he decides to enforce the secondary sanctions on foreign countries that operate in Iran. If this happens, some of the ventures that were already signed will be frozen, and potential investors will be deterred from entering the Iranian market.