PANORAMA

March 2016

IRAN: SHARP TURN AHEAD, DRIVE CAREFULLY

COFACE ECONOMIC PUBLICATIONS

By the Group Mediterranean & Africa Economists

After five years of sanctions, Iran is finally to rejoin the global community. The return of Iran should have an effect on international growth through the oil channel but above all, will bring huge changes to Iran itself. International sanctions have impacted the Iranian economy. Two consecutive years of negative growth and runaway inflation have tested Iran's resistance model to its limit. The lifting of the EU embargo will allow Iran to revive its oil sector and return to the global market. The country is perceived as a new Eldorado, with its 78 million potential consumers. More over, with its huge oil and gas reserves, skilled labour force and strategic location, Iran is holding all the cards to become one of the top emerging economies during the next few years.

The lifting of sanctions, following the P5+1 agreement, will have a significant effect on raising Iran's output. Coface expects real GDP growth to stand at 3.8% this year.

However, moving from autarky to openness is a sharp manoeuvre to manage. The country may face adverse effects from trade liberalisation. The surge in capital inflows and increased oil exports could lead to an exchange rate appreciation that would be a hurdle to the competitiveness of non-oil exports. Indeed, fear of a 'Dutch Disease syndrome' remains present over the medium term.

The unfavourable global environment and structural problems may delay the gains expected following the removal of sanctions. The rebirth of the oil sector is likely to be slower than projected, due to the lack of investment and the downturn in the oil market. The low price of the oil barrel may cost Iran 2.8% of its GDP if it remains unchanged (i.e. 33 USD/b).

Morever, the country's isolation, obsolete infrastructures and weakened banking system will challenge the positive dynamics of its reintegration into the global world trade market.

Nevertheless, there are sectors other than oil that will benefit from the lifting of sanctions such as the automotive industry which, prior to the sanctions era, was the largest car producer in the Middle East.

1 IRAN: A NEW ERA AFTER THE LIFTING OF SANCTIONS

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"The lifting of sanctions will be gradually effected over the next ten years, while over a period of fifteen years the sanctions can be restored in case of failure by Tehran to meet its requirements."

Following the 1979 Iranian Revolution and the seizure of the US Embassy in Tehran, the United States imposed restrictions on activities with Iran. These sanctions became broader in 1995 and again in 2005. By late 2010, other Western countries had imposed similar sanctions on Iran, discouraging international companies from the Iranian market if they wished to avoid problems with Western governments and regulations. In 2012, the US banned banks from completing oil transactions with Iran, while the European Union introduced a boycott on Iranian oil exports. The EU also introduced further sanctions, which focused on trade and banks, including the asset freezing of companies and individuals providing technology to Iran.

The US banned almost all non-humanitarian US trade and investment with Iran and prohibited companies from knowingly transshipping US goods to Iran via other nations. Sanctions included the freezing of Iranian assets including gold, bank deposits and other properties. The sanctions also limited Iran's ability to extract and refine oil and gas – activities that the Iranian economy relies on. The aim of blocking oil exports was to isolate Iran financially and to prevent it from developing nuclear weapon capacities.

After more than 10 years of diplomatic attempts to address Iran's nuclear policy, Iran and the P5+1 countries (China, France, Russia, the United Kingdom, the United States and Germany) reached a preliminary framework agreement in July 2015. The deal saw Iran agreeing to restrict its atomic programme, while the US, EU and UN in return promised to lift sanctions. The sanctions were officially lifted after the International Atomic Energy Agency (IAEA), the UN nuclear watchdog, said that Iran had fulfilled its obligations in July 2015. Iran has limited its LEU (low enriched uranium) stock and removed the heart of the heavy water reactor at Arak in order to reduce its production of plutonium[1].

"The lifting of sanctions will particularly support private consumption and exports."

The lifting of sanctions will be gradually effected over the next ten years, while over a period of fifteen years the sanctions can be restored in case of failure by Tehran to meet its requirements. The removal of sanctions will revive the Iranian economy, particularly through the recovery of foreign trade and investments.

The impact of lifting sanctions on Iran's economy

Iran is the second largest economy in the Middle East and North Africa (MENA) region. According to the IMF, its GDP stands at 416.5 billion USD. Following two years of recession, the economy registered a growth of 4% in 2014, on the back of the easing of trade and financial sanctions through an interim agreement with P5+1 countries, in November, that supported economic activity (although it was short-lived).

Prior to 2011, the Iranian economy attracted, on average, 4 billion USD (nearly 1% of GDP) of greenfield investments per year. Most of this was directed towards the oil and gas and manufacturing sectors[2]. The tightening of sanctions after 2012, however, brought FDI flows to a halt. This had a negative impact on the country's accumulation of technologies and expertise. With the removal of sanctions, the country's national authorities expect to attract foreign investments of at least 50 billion USD a year. This figure is far above the 2.1 billion USD of FDI inflows that Iran attracted in 2014. In October 2015, the Ministry of Roads and Urban Development organised a major conference to present investment opportunities, valued at 28 billion USD.

Key sectors that should lead the economy's recovery in the post-sanctions period include transportation, housing and urban development.

1. IAEA Director General's Statement on Iran on January 16th, 2016.
(https://www.iaea.org/newscenter/news/iaea-director-general%E2%80%99s-statement-iran)
2. World Bank, MENA Quarterly Brief, Economic Implications of Lifting Sanctions on Iran, July 2015

Table 1: Iran macro indicators

	2014	2015f	2016f
GDP (%)	4.3%	0.5%	3.8%
Current acc. bal. (1)	4.5%	2.4%	1.5%
Budget balance (1)	-1.1%	-2.9%	-1.6%
Government debt (1)	15.8%	16.4%	15.3%
Inflation (2)	15.5%	15.1%	11.5%

(1) % of GDP
(2) Yearly average
Sources: Official statistics, IMF, BMI, Coface

Besides the oil and gas sector that the economy relies heavily upon, and the other industries mentioned above, the country has opportunities in almost every sector (see section II Forecast for Iranian sectors).

During his trip to Europe in January 2016, President Rouhani sealed a 25 billion USD deal to buy 118 civilian aircraft from French company Airbus. He also signed deals worth approximately 15 billion USD with Italian companies from various sectors, including transportation, infrastructure and machinery. The country has also announced a "new era" of cooperation with China, with whom it has signed 17 contracts, including for the construction of two nuclear energy plants in southern Iran. National authorities expect trading volumes between the two countries to rise to 600 billion USD within the next decade, up from around 55 billion USD in 2014.

Coface expects GDP to grow by 3.8% during the upcoming fiscal year, which will begin in March 2016. Following the signature of the interim nuclear deal in 2013, the economy witnessed a short lived boost, before lower oil prices and delayed consumption and investment expenditure resulted in a slowdown. The medium-term economic outlook appears to be better, as lower trade and financial transaction costs, easier access to international markets and higher foreign investments should support GDP growth. According to the IMF[3], lower trade and financial transaction costs should add around 0.75 to 1 percentage points to GDP growth.

Iran's economy is mainly driven by private consumption; which accounts for 39% of GDP[4] . With the lifting of sanctions, this share may gradually increase over the upcoming period, as the easing of inflationary pressures would support the purchasing power of households. The greater availability of foreign goods should also boost private demand. As regards fixed investments (27% of GDP), huge obstacles such as corruption, heavy bureaucracy and nepotism could delay a solid recovery despite the soaring interest of international companies to return to the Iranian market following the removal of sanctions. Government consumption (11% of GDP) may see a small increase, thanks to fiscal consolidation which includes efforts to boost tax revenues, reform subsidies and tighten spending. Iran is trying to improve its tax revenues, as only around 40% of the country's economy currently pays taxes. As the sanctions are removed, the government may try to accelerate subsidy reforms and its plans for privatisations. Despite this, the budget balance would remain in the negative zone, as the country increases social and educational spending. Iran's growth will also benefit from the spillover from higher oil production and exports, which account for 22% of GDP. Iran's hydrocarbon exports are also expected to rise with the country's return to the global market. Iranian oil production has been negatively affected by the restrictions imposed on exports. With the rebuilding of this sector (mainly by foreign investors such as Royal Dutch Shell, BP, Eni and Lukoil, which now see a better investment climate in the country), Iran's oil production could reach 3.7 million bbl/day in 2016 and 4.4 million bbl/day by 2020. The non-hydrocarbon economy will also benefit from a resurgence in oil production, as well as from renewed economic confidence.

"Iran's economy is mainly driven by private consumption; which accounts for 39% of GDP."

With the implementation of sanctions and Iran's ban from international financial markets, Iran's currency, the rial, lost around two-thirds of its value against the US dollar. This situation caused a sharp increase in inflation that reached 40% in 2013, linked to the rising prices of basic food as well as soaring fuel prices. President Rouhani's administration, which took power in 2013, has curbed inflation. With the roll back of global sanctions, authorities now see inflation declining to single digits by 2017. The Statistical Center of Iran announced that the inflation rate for the 12-month period ended on the last day of the tenth Iranian calendar month (January 20) was 12%, compared to the same period in the previous year.

With inflation falling to below 15%, the government saw an opportunity to loosen monetary policy. In October 2015, it unveiled a new economic stimulus plan, designed to curb inflation and support the economy. According to a media report published by Reuters, the plan foresees a cut in the central bank's interest rate, a cut in banks' legal reserve requirements to 10% from 13% and a lowering of the interbank interest rate to 26% from 29%. The government would also pump 75 trillion rials (about 2.2 billion USD), approximately 0.5% of GDP, into the country's development budget within a fortnight.

Although Iran's current account balance shrank from 11% of GDP in 2011 to 4.5% in 2014, due to the sanctions restraining oil export volumes, it remained positive. Since mid-2012, revenues from oil exports have fallen by more than 60%, due to the fall in volumes and lower oil prices. During the same period, non-oil exports have risen from 5% to 8% of GDP. From 2012 to 2014, trade flows declined consistently, due to sanctions. Iran's imports of goods dropped by 13.8% yoy, to 67.1 billion USD, while exports plunged by 32.4% to 98 billion USD.

3. IMF 2015 Article IV Consultation
4. BMI, Iran Country Risk Report, Q2 2016

Trade flows would have been higher by at least 17 billion USD, had sanctions not been implemented. On the other hand, imports declined by around 12 billion USD (around 3% of GDP), due to the sanctions related higher costs of doing business and the depreciation of the local currency. In 2015, the rial's official exchange rate depreciated by around 10% against the US dollar, reaching 30, 178, as of mid February 2016. Under the cumulative effects of the lifting of restrictions and the fall in transaction costs for exports, Coface expects the current account surplus to GDP ratio to stand at 1.5% of GDP in 2016. The tightening of international sanctions also modified the composition of Iran's major trade partners. While during the first . half of 2000, Europe was Iran's major trade partner, accounting for more than one third of Iran's total exports and imports, since 2012, India, China and South Korea have replaced European countrie. Third of Iran's total exports and imports, since 2012, India, China and South Korea have replaced European countries .

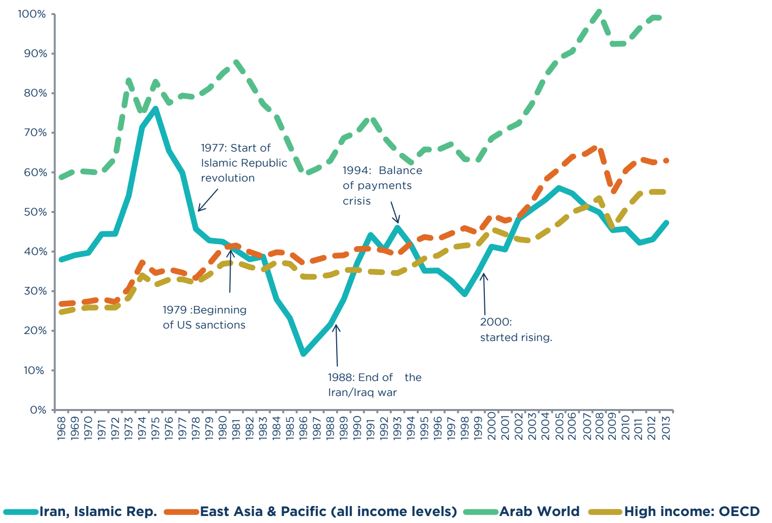
Limitations remain..

As highlighted in the first section of this report, the lifting of sanctions following the P5+1 agreement will have significant short term and long term effects on raising Iran's output. However, transitioning from an autarky regime with four years of sanctions, towards trade openness in the context of an unfavorable environment, may limit the gains made through the removal of sanctions.

Moreover, isolation, lack of investment and a weakened banking system will hamper the positive dynamics of reintegration into the global world trade market.

Graph 1: Trade openness index

(Exports and imports of goods and services measured as a share of gross domestic product)



Sources : World Bank national accounts data, and OECD National Accounts data files.

Transitioning from autarky to trade openness

The twenty year period of sanctions changed Iran's economy. The combination of the 2012 oil embargo by the EU and the ban on oil-related financial transactions led to a significant decline in oil sales. The international trade ban has been associated with macroeconomic dislocations in the country's domestic economy. Restrictions on imports, parallel foreign exchange markets and high inflation, have all contributed to a significant slowdown. The political economic framework, based on "an economy of resistance", has encouraged the deflection of imports towards domestic production, through subsidies and state support instruments. Years of sanctions have encouraged Iran to diversify the fabric of its domestic production, by protecting it from international competitiveness.

Technical constraints remain

Iran should greatly benefit from the lifting of sanctions but export growth could, however, be weaker than expected. In the short term, the reopening of Iran's economy to global trade should be progressive. Iran is the biggest market outside the WTO. The country is relatively closed and the authorities will favour a gradual opening of tariff and non-tariff barriers. Iran has extensive tariffs on imports and exports across a range of goods in the country. Imports valued at over US$50,000 are subject to a pre-shipment quantity and quality inspection. In addition to the policies on tariffs, regulatory constraints and bureaucratic inflexibility are likely to hamper trade growth in the short term. According to the World Bank's 'Doing Business' rating, the time and costs associated with procedures in Iran are high compared to other countries. The gradual reopening of banking channels will also limit export growth. Although, Iranian banks now have access to the swift system, money transfers are still not operational. The lack of foreign reserves in banking balance sheets may also hinder the increase in trade flows.

Table 2: Doing business in Iran

Indicator	Iran, Islamic Rep	Middle East & North Africa	OECD high income
Time to export: Border compliance (hours)	107	65	15
Cost to export: Border compliance (USD)	565	445	160
Time to export: Documentary compliance (hours)	159	79	5
Cost to export: Border compliance (USD)	143	351	36
Time to import: Border compliance (hours)	148	120	9
Cost to import: Border compliance (USD)	660	594	123
Time to import: Documentary compliance (hours)	284	105	4
Cost to import: Documentary compliance (USD)	197	385	25

Source: World Bank, Doing Business 2016

Loss of price competitiveness resulting from the high rial ...

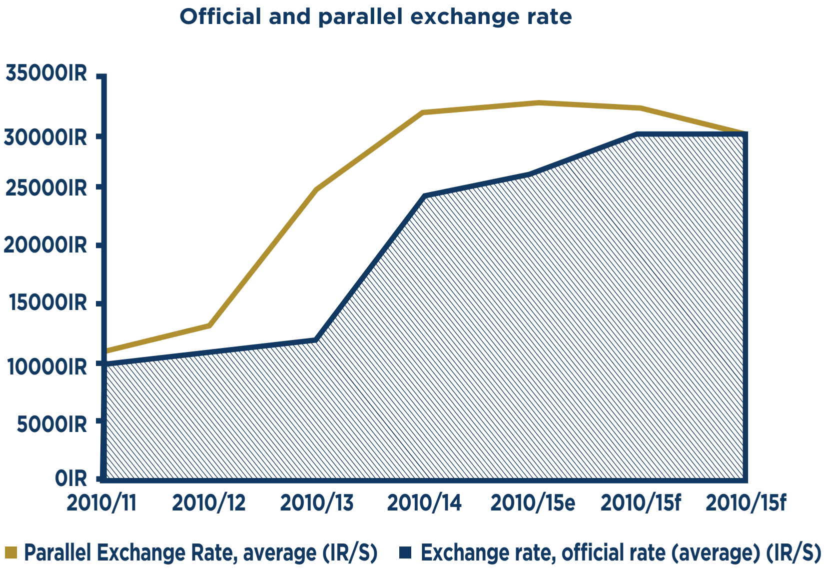
The sudden shock of trade openness may have an adverse effect on the country's exchange rate. Iran has a dual exchange rate system, with an official fixed rate for imports of selected priority goods and a bureau market determined rate for all other current account transactions. Uncertainty over Iran's external environment has led to bouts of volatility in the parallel market. The differential between the two exchange rates exceeded 30% when the parallel market reached its lowest point, in 2012. The return of frozen assets and an increase in oil revenues should induce an appreciation of the exchange rate, allowing the CBI to unify the dual foreign exchange rate systems. According to an interview with the CBI's governor in early January, a single foreign exchange system will be introduced into the country within six months. The appreciation of the real exchange rate would, however, be unfavourable to local businesses. Although Iran's central bank is considering conducting an accommodative exchange rate policy by devaluing the rial, it could be constrained by the disinflation policy.

The opening shock could therefore penalize the sectors that are the least prepared against outside competition such as agriculture and industry. As noted in Devarajan, S. and L. Mottaghi. (2015)[5], Iran went through a similar scenario in 1990, following the end of the war between Iran and Iraq, when the country experienced a significant increase in oil exports. The oil service sectors were then heavily subsidised, in order to compensate for their loss of competitiveness. This policy may have allowed Iranian companies to exist in a self-sufficient environment that obstructed their development (difficult access to intermediate consumption, little technical progress, etc. ...).

...Could lead to a lack of diversification

In the medium term, liberalisation is expected to generate an efficiency boost but the risk of the Dutch Disease[6] scenario remains. Productivity shocks, due to the removal of trade restrictions, would effectively lower the prices of imported financial and transport services and improve the efficiency of sectors with comparative advantages, such as oil. Trade openness, however, may have an adverse effect on the most vulnerable sectors, by substituting domestic production with more competitive imported goods. Substituting domestic production with imports may also affect non-oil exports. Haidar (2015)[7] shows that one of the effects of sanctions was the deflection of non-oil exports to Iran friendly destinations. Moreover Haidar demonstrates that exporters reduced their product prices as they deflected exports to new destinations. The weakness of the Iranian currency and the impermeability of the sanctions regime encouraged not only the diversification of the national economy but also new destinations for non-oil exports. Furthermore, even though the oil sector currently accounts for 80% of exports, it only represents 0.7% of total employment while non oil sectors represent 38% of employment.

Graph 2: Official and parallel exchange rate



Sources: IIF, November 2015 database

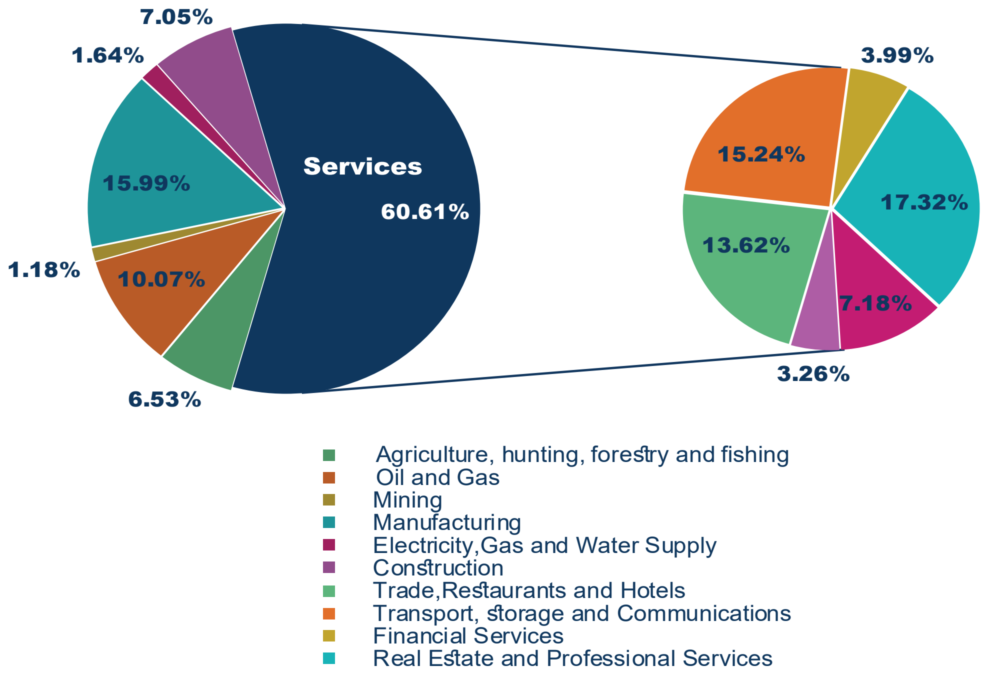
"We are concerned that the Dutch Disease returns; what Iran has experienced for several times before".

Minister of Economic Affairs and Finance
Ali Tayyeb-Nia, Mars 2015

5. Devarajan, S. and L. Mottaghi. (2015) "Economic Implications of Lifting Sanctions on Iran" Middle East and North Africa Quarterly Economic Brief, (July), World Bank, Washington DC / World Bank, MENA Quarterly Brief, Economic Implications of Lifting Sanctions on Iran, July 2015
6. large inflow of foreign currency results in an appreciation of the local currency and so makes the manufacturing sector less competitive.
7. Haidar, J. I. (2015). Sanctions and Exports Deflection: Evidence from Iran. Paris School of Economics, Mimeo.

Graph 3: GDP components in Iran

Share of economic sectors in gross domestic product in 2013/2014



Sources: Central bank of Iran, Coface

Lack of confrontation from international competition and weak imports of capital goods have resulted in reduced non-price competitiveness. Without an appropriate industrial policy to protect its most vulnerable sectors, Iran may experience a contraction in its domestic fabric. According to the IMF quality index database, Iran's export quality remains low for all commodities (although it is still higher than in other less diversified countries such as Nigeria and Algeria). The dataset only makes it possible to analyse exports and production quality until 2010 but we can reasonably well assume that with the strengthening of sanctions in 2012, the quality index may have taken a downwards path. One of the main reasons to explain this inflection could be the limited access to quality input and the monopoly position on the domestic market. The car industry is a good example of this. This is Iran's second largest industry, following oil, and one of the country's most protected sectors (see page 11). Prior to 2012, the two main Iranian car makers had joint venture partnerships with international car manufacturers. Following the UNO ban, foreign car companies were obliged to leave the market. In August 2015, Kodhro (the largest car manufacturer) was targeted by a hard hitting boycott campaign, which accused the company of cheating Iranian consumers by selling them overpriced, low quality cars.

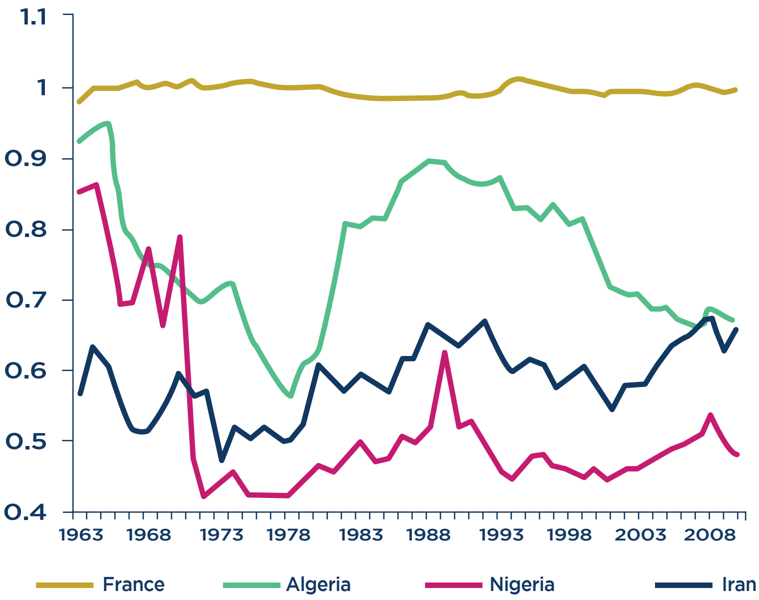
The changes in domestic production are also likely to affect the employment structure and wages. The World Bank estimates that the Iranian economy needs to create five million jobs over the next 5 years, under the assumption of a 5.5 percent GDP growth rate, to keep the unemployment rate at 10 percent. Without a surge in investment into the tradable sector, the appreciation in the real exchange rate will put pressure on agriculture and industry and encourage the service sector. This could be disruptive for the work force, which has greater dependency on tradable sectors. Trade openness should also have an effect on wages. According to Ianchovichina, Devarajan, and Lakatos (2016)[8] , the expansion of Iran's oil sector should raise the real price of capital by 7.8 percent, as the oil sector is an intensive user of capital. Wages increases, which will come from the spillover effects of the oil sector, should be equivalent to 1.0 % for skilled and 0.5 percent for unskilled workers.

"One of the main reasons to explain this inflection could be the limited access to quality input and the monopoly position on the domestic market."

8. Ianchovichina, E., Devarajan, S., & Lakatos, C. (2016). Lifting economic sanctions on Iran: global effects and strategic responses. World Bank Policy Research Working Paper, (7549).

Graph 4: Quality evolution overtime : the case of oil countries

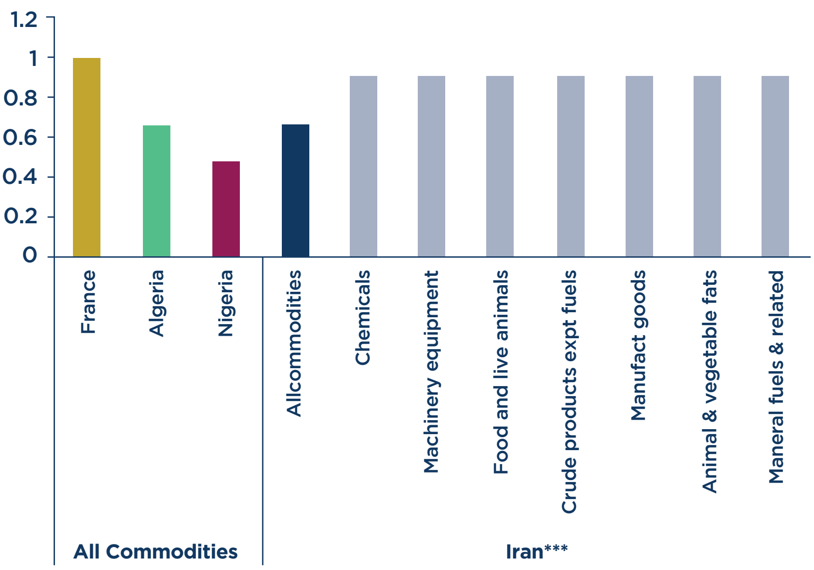
Export Quality Index



Sources: IMF, The Diversification Toolkit Export Diversification and Quality Databases (Spring 2014)

Graph 5: Export quality indexes 2010**

It measures across different aggregation levels of export the export quality



**Higher values for the quality indices indicate higher quality levels
*** Only Iranian sectors with comprarative advantage are represented

An unfavourable global environment

The lifting of sanctions comes during a challenging environment. Sluggish world trade, subdued oil markets and regional turmoil, are all likely to dampen the initial positive impact from the lifting of sanctions and the reduction in trade costs. Moreover, Iran's return should have a significant effect on the oil market itself. According to Devarajan, S. and L. Mottaghi. (2015)[9], the possible addition of one million barrels a day (mb/d) from Iran, assuming no strategic response from other oil exporters, would lower oil prices by 14 percent or $10 per barrel in 2016. As the Iranian economy is heavily reliant on oil outcomes to boost its domestic economy, the fall in revenues induced by the oil market situation would constrain public investment and the government's policy support for post sanction growth.

According to Ianchovichina, Devarajan and Lakatos (2016), the potential welfare gain[10] from the removal of embargoes depends on several assumptions. The best scenario would be a strategic response from oil exporters to induce a reduction in the world's oil supply. In this case, the benefits from the removal of sanctions could reach 30 billion dollars or an increase in per capita welfare of 6.2%, due to the effects of stronger terms of trade. This scenario is made under the assumption that Iran is able to sell pre-embargo quantities at world oil prices that are 13 percent higher than the current ones. However, if there is no change in price levels, Iran would benefit from an increase of 18 billion dollars (or an increase in the GDP per capita of 3.7%). In summary, the unfavourable conjuncture of oil market prices could cost Iran a welfare gain of 12 billion dollars, or 2.8% of GDP.

Foreign Direct Investment (FDI) flows, following the lifting of sanctions, will also be affected by the unfavourable economic environment. FDI declined by billions of dollars following the tightening of sanctions in 2012. Prior to 2011, FDI to the Iranian economy averaged around $4 billion a year, in the form of greenfield and brownfield investments. Oil & gas, along with manufacturing, were the two main sectors receiving FDI. Oil & gas industries attracted over half of total FDI inflows. The lifting of sanctions is expected to encourage a progressive recovery in the foreign investment that the authorities rely on to

9. Ibid. Devarajan, S. and L. Mottaghi. (2015)
10. The economic welfare that is gained as a result of increasing or decreasing the production and consumption of goods or resources

support investment needs, as well as access to technology spillovers. The oil & gas investments needed to maintain Iran's oil production capacity are estimated to be between $130 - 145 billion by 2020. The large South Pars gas field alone will require $100 billion. According to Mohammad Khazaei, the Iranian deputy minister of economy, the country aims to attract 7 billion dollars of foreign direct investment by the end of the current Iranian calendar year (March 19, 2016). To enhance the country's attractiveness, Iran is focussing on improving its business climate through reforms such as the Foreign Investment Promotion and Protection Act (FIPPA). The FIPPA will allow tax exemption in strategic sectors targeted by the authorities. It will also provide other incentives to attract foreign multinational companies, including the development of a free zone and a programme of industrial parks. Nevertheless, the downwards trend in oil prices and regional turmoil may hamper the recovery of FDI outflows, especially in the oil & gas sector. The World Bank expects that FDI inflows will range between $3 to $3.2 billion in 2016 and 2017 respectively, if economic growth rebounds to 5.5% in 2017. According to the IMF, FDI recovery is likely to be slower, with foreign outflows close to zero in 2015/2016 and almost $2 billion in 2016/2017[11] .

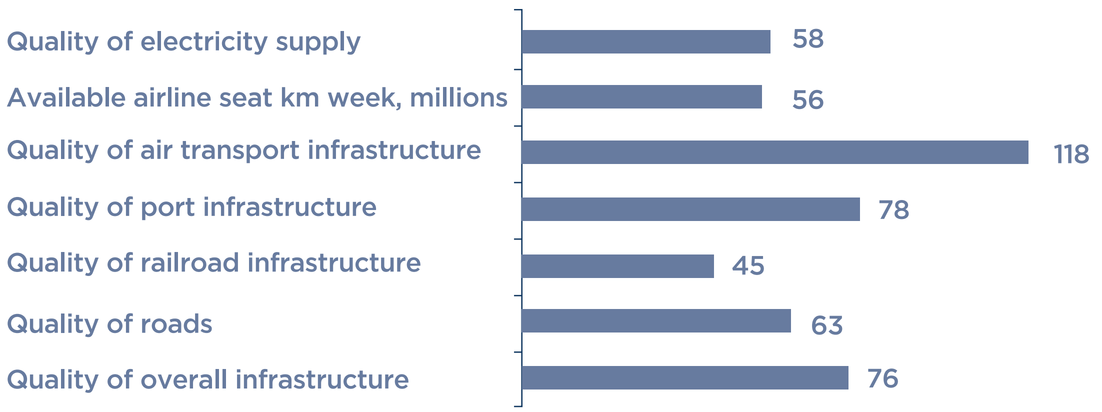
Infrastructure weaknesses

Gains from the lifting of sanctions will also be limited by infrastructural deficits. In terms of infrastructure, Iran is comparatively highly-developed, with 99 airports and over 10,000 kilometers of railway. However, the country's infrastructure has been falling into obsolescence, with a lack of investment during the period of sanctions. The low growth rate and the contraction of oil revenues due to the embargo, limited the government's ability to invest in infrastructure utilities. Indeed, the lack of viable infrastructure could represent one of the main bottlenecks to the expected rise in growth, post sanctions.

Even with the fall in trade costs, the lack of infrastructure will limit the expected growth in foreign trade. The efficiency of Iran's transport infrastructures has declined and the shipping industry has seen the quality of its ports severely deteriorate over the past decade. The Global Competitive Report from the World Economic Forum 2015-2016, ranks Iran 76 out of 144 countries for the quality of its infrastructure, 63 for the quality of its roads, 118 for the quality of its air transport infrastructures and 78 for the quality of its port infrastructures. Iran's transport infrastructure poses a key challenge to the development of its non-oil industries, especially tourism and manufacturing, and the efficiency of its transport network is low. The World Bank's Logistics Performance Index measures logistical efficiency from 1, for the least efficient, to 5 for the most efficient. Iran was rated at 2.42 in 2012, while Egypt reached 3 and Saudi Arabia 3.22.

Iran is planning to invest massively in its public infrastructure. The government intends to take on several projects, once sanctions are lifted. These projects include highways, railroads, ports and airport facilities. Significant investments are planned for the development of the national road network and to improve

Graph 6: Iran's rank in the global competitiveness report 2015-2016



Source: Global Competitiveness report 2015-2016

11. IMF Executive Board Concludes 2015 Article IV Consultation with Iran Press Release No. 15/581 December 21, 2015

connections to neighbouring countries. Among the projects presented, the authorities intend to extend the road network by building 745 kilometers of freeways, 5,626 kilometers of highways and 2,970 kilometers of main roads. The purchase of over 100 Airbus aircraft to complete the Iranian civilian fleet, along with the construction of two additional transit terminals at Imam Khomeini International Airport, will support the development of the country's air transport links.

However, the contraction of fiscal revenues could pose problems to the funding of public investments. Iran's investment needs are substantial and an important share of current investments is already absorbed by the construction sector. According to CBI data, private investments accounted for 75% of total investments in 2013/2014. Of these, 60 % were directed to the construction sector, while the rest was assigned to production capacities. Furthermore, public investments are limited by the important subsidies and supports made to the population. The budget bills presented in December 2015 were based on an oil price per barrel of $40 (above the current market price). The government is counting on the return of frozen assets, an increase in oil exports and capital inflows to finance its required investment but all of these are likely to fall short of expectations.

A weak banking sector

The weakness of the banking sector is another key challenge to faster growth in Iran. The Iranian banking sector is dominated by state-owned banks. Six of the largest are commercial banks (the main one being Bank Melli) and five are specialised banks. Iranian banks operate according to Islamic principles. The strengthening of sanctions in 2012 and the exclusion of Iranian banks from the international trading system have enfeebled the banking sector. Their profitability remains low and the return on assets was estimated at only 1% in 2012/2013. Furthermore, Iranian banks do not apply international macro prudential rules and were protected from international competition. Bank balance sheets remain weak and the banking system represents a risk. Banks are under capitalised and subject to high levels of non-performing loans (12%). They are also in competition with unlicensed financial institutions (UFIs) which are not within the same regulatory framework but absorb 16% of deposits. Banks are also exposed to public debt. According to the IMF, the exact amount of public debt (government and government related entities, as well as public company debt) is not known precisely, but an important share of it is owed to the banking system. In addition, the contribution made by banks to growth, via banking credit, is not efficient and is heavily controlled by the authorities.

Moreover, the ability of Iran's banking system to meet the rising financing needs of post-sanction growth is questionable. Foreign banks will take time before they return to the Iranian market and, at this stage, are still adopting a wait and see approach. The main reason for this cushioned position, especially for European banks, is the risk of being banned or sanctioned by the US market. Even if nuclear sanctions have been lifted, Iran is still subject to other sanction regimes in the US. The shadow of "snap back"[12] sanctions also remains a major consideration for foreign banks in their commitment to the Iranian market. Risks of a return to a new sanction era are continuing to have a discouraging effect on financial institutions.

2 FORECAST FOR IRANIAN SECTORS

According to Coface, two sectors are good illustrations of both the untapped potential economy and the challenges faced by Iran entering the market oil & gas and the automotive sector. The lifting of sanctions will have the biggest impact on Iran's energy sector, as the country has the world's fourth largest proven oil reserves and second largest proven gas reserves. Iran's economy is mainly reliant on the oil and gas sector. Prior to the sanctions, Iran was the most important car producer in the Middle East. The automotive sector is the country's second largest sector after oil and gas, accounting for 10% of GDP[13] .

The rebirth of Iran's energy sectors

Iran holds the world's fourth largest oil reserves, following Venezuela, Saudi Arabia and Canada. Much of Iran's reserves are onshore (70%) and 80% are located in the Khuzestan province, in the country's south-west, near the Iraqi border.

According to data from the US Energy Agency (EIA), 50% of Iran's reserves are concentrated in five major oil fields. The Marun oil field is estimated at 22 billion barrels, the fields of Ahwaz at 18 billion barrels and the fields of Aghajari at 17 billion barrels. The sector's structure is dominated by a state owned monopoly. The National Iranian Oil Company (NIOC) controls all upstream and downstream oil and gas activities, while refining and distribution activities are carried out by the state run National Iranian Oil Refining & Distribution Company. Foreign companies had limited access to Iran's oil sector. The Buyback contract (which was first introduced in the 1990s), was an attempt to bridge the gap between the country's need to attract foreign investors and the ban on foreign ownership of natural resources under the Islamic Republic's constitution. Commonly used since its introduction, the existing buy back contract model is a short term service contract between the state owned National Iranian

12. The snapback clause is the ability to snap back sanctions if at any point Iran materially breaches its commitments under the JCPOA.
13. Ibid Devarajan.S & Mottaghi (2015).

Oil Company (IOC) or one of its subsidiaries, and a foreign company. Under this type of contract, the IOC agrees to explore or develop a field and to fully fund the project but does not gain the physical assets of the development. Instead, it receives an annual repayment rate based on a pre-agreed rate of return.

Iranian oil fields are mostly mature but their production was limited. The country has not reached its full productive potential and the occurrence of sanctions on Iranian oil exports from 1995, reinforced in 2011, accelerated the sector's obsolescence. The EU's oil ban and the slowdown of Asian demand have greatly limited the sector's economic perspectives. Over a period of one year, Iran's oil exports declined from 2.8 Mb/d in July 2011, to below 1 Mb/d in July 2012.

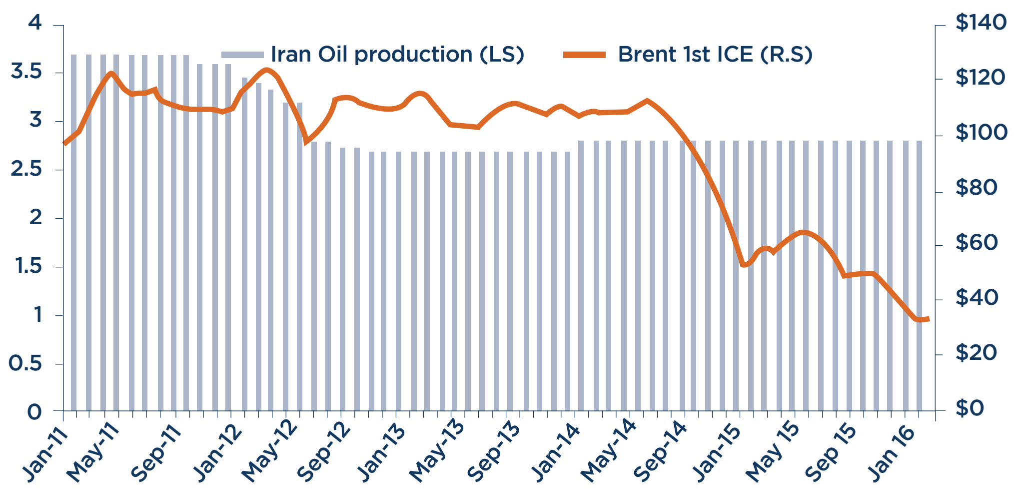
The lifting of sanctions should lead to an increase in the production of hydrocarbons - but this could be constrained by the poor prospects of the oil market.

According to the International Energy Agency, Iran's crude oil production, which averaged 2.8 Mb/d in 2015, is forecast to average over 3.1 Mb/d in 2016 and almost 3.6 Mb/d in 2017. The gradual opening of the country should also encourage investment into the oil sector. With the proper investments, Iran could eventually reach a production of 4 Mb/d. Several foreign companies that were present before the sanctions could re-enter the market.

Nevertheless, the upgrading of infrastructures will be costly. The sector's financing needs amount to over $200 billion according to the Iranian Minister of Industry ($130 according to the World Bank's estimates). Furthermore, in the current context of oil price declines, the entry of Iran into the global market may further accentuate the imbalance between supply and demand thus leading to a decrease in the profitability of investments in the medium term. The difficulties encountered by the major oil companies in the context of falling prices could slow their investments in Iran. To increase the attractiveness of its oil sector, the Iranian authorities have introduced a new integrated oil contract (IPC), which should offer attractive commercial terms to oil companies. The Iran Petroleum Contract (IPC) is set to replace the traditional buy back scheme. The IPC has had to face much criticism within Iran since it was launched. A final version of the contract has been revised by the NIOC and should be presented in April 2016.

Iran has the second largest proven gas reserves in the world, estimated by the American Energy Agency (EIA) at 33.6 trillion in 2015. The proven gas reserves are predominantly offshore non associated fields (62% of total). Onshore reserves are divided between non associated gas fields (19%) and associated gas fields (19%). The giant South Pars deposit that Iran shares with Qatar comprises two thirds of all proven reserves, but, the country's development of its large gas fields has been limited. The gas sector, as the oil sector, has been constrained by the strengthening of sanctions. The gradual lifting of export restrictions should allow Iran to gradually increase gas exports. However, the gas market remains highly competitive. Iran will need to catch up with Qatar or Australia, who both invest massively in innovations and infrastructures.

Graph 7: Iran oil production since sanctions



Sources: EIA Bloomberg, Coface

Inset n°1

THREE QUESTIONS TO CLÉMENT THERME

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What are the issues behind February's elections? Do they represent a risk to continuation of the country's opening policy?

The main issue behind the vote is the opportunity for the Iranian political system to open up to Western investments in key strategic sectors such as the oil and gas industries or the automotive sector. The strategic decision of President Rohani to open a dialogue with the West received a large support of the Iranian public opinion in the 26th of February elections for the majles (Iranian parliament) and the Assembly of Expert which is in charge of choosing the Supreme Leader of the Revolution. The elections of key allies of President Rohani such as Ayatollah Rafsanjani (he ranked first in the list of the Moderates in Tehran for the Assembly of Expert) and Mohammad-Reza Aref at the majles is a strong message of the majority of the Iranian population that they want more economic relations with the West.

What will happen to the agreement if a republican president came to be elected and returned on the US sanction remoral toward non US citizen ?

The Joint Comprehensive Plan of Action (JCPOA) of the 14th of July 2015 was endorsed by a UN Security Council resolution (UNSC) 2231 (2015). This is a legally binding resolution and as a permanent Member of the UNSC, the United States will probably not condemn the resolution. Even a Republican president will have to comply to the Resolution and in the case of denouncing the JCPOA, China, Russia and European allies will not follow such a move if Iran respects its engagements. The political risk with the end of Obama's presidency is broader. A new American president could try to impose new nuclear non-related sanctions such as Human Rights sanctions or for the development of the Iranian ballistic military programme. Last but not least, a new American President could be more receptive to the Israeli and the Saudi pressures for a more hard-line diplomacy towards Iran.

What could you tell us about the Iran and Saudi Arabia rivalry?

The Iranian opening is perceived by Saudi Arabia as a threat for the Sunni Arab community in the Middle East. The Saudi-led military intervention in Yemen of March 2015 was a "message" to Iran against what Ryad perceived as the so-called "Shia Crescent" against its allies in the region. In return Iran portrays itself as a victim of "takfiri" Islam broadly defined as Muslims supporters of the Wahhabi doctrine. Since the Syrian war of 2011 this regional rivalry intensifies in the region but the two powers are not fighting directly. In this Cold War, France followed the President Obama strategy to rebalance US regional diplomacy from an exclusive alliance with Israel and Saudi Arabia to a decrease in the hostile relationship with Iran. The rise of tensions between the two regional powers complicates the diplomatic objectives of Western powers to preserve cordial relations with the two countries. Nevertheless, with the economic rapprochement between the EU countries and Iran and the rise of Daesh, one has to consider the new dynamics in Iranian-Western relations. This can be an asset to pressure the two rivals in order to avoid a regional confrontation detrimental to the people of the Middle East. But this can also be seen by Israel and Saudi Arabia as a threat to their regional diplomatic positions in the region.

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Iran's automotive industry: A slow revival of the second largest sector

For years, international sanctions have been limiting the development of Iran's automotive industry which was previously the largest car producer in the Middle East. The automotive industry accounts for more than 10% of Iran's GDP. Following Western sanctions and the depreciation of the local currency, not only did the output volume drop (from approximately 1.6 million cars per year to less than 745,000), but automotive prices soared by about 300%[14]. The rial's depreciation increased the cost of imported parts for the automotive industry, causing a slowdown in production and decline in employment. The car sector is estimated to account for 4% of the total workforce.

With the relief of sanctions, the Iranian administration is now focusing on reviving this important sector. During his trip to Europe in January 2016, President Rouhani signed several deals related to the car industry. A joint venture deal, reached between France's PSA Peugeot Citroen and Iranian automaker Khodro, has plans for the two companies to modernise a factory near the capital, Tehran, and to start producing cars by mid 2017. According to media reports, the initial production target stands at 200,000 vehicles per year and the French company will invest a total of 400 million EUR within five years.

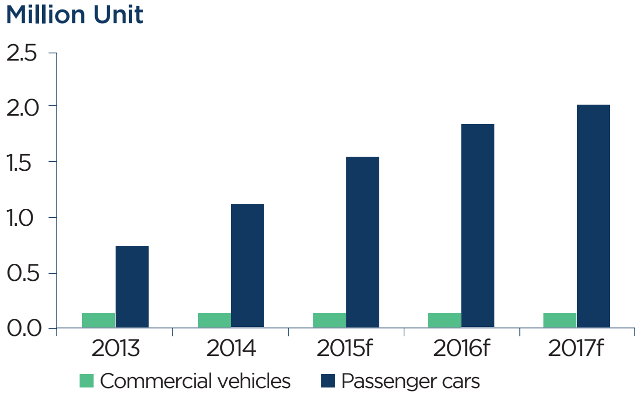
"The automotive sector which accounts for 10 of GDP and 4% of employment, should gradually reach its pre-crisis output levels."

Waiting for Western cars

As mentioned, the automotive sector will be one of the biggest beneficiaries following the lifting of sanctions. Iranian consumers are hungry for international brands and the removal of sanctions will provide the opportunity for further Western car producers to enter the market. The demand for vehicles will gradually increase and the growing young and brand-conscious population will be one of the main supports for demand. As at 2015, Iran's population was estimated at 75 million people. Of these, 37.5 million belong to the 15-40 year old age group[15] .

Higher economic activity in the post sanctions era and improved conditions for financing infrastructure projects could sustain demand for commercial vehicles.

Graph 8: Iran automotive sales (million)



Sources : BMI, Coface

Major car makers rush into Iran

Iran Khodro Company (IKCO) is the largest auto manufacturer in Iran. Founded in 1962, IKCO produces its own range and produces under license for other manufacturers. In 2010, according to IKCO's website, it produced 755,555 cars, accounting for around 50% of the market.

Société Anonyme Iranienne de Production Automobile (SAIPA) is the second largest Iranian auto manufacturer. It produces passenger and commercial vehicles, based on models previously manufactured by Kia and Renault. It is also focusing on developing its own models, such as the Tiba. In February 2015, the media reported that Saipa saw both production and sales rise by 32% in 2014.

Following the removal of international sanctions, the interest of international car manufacturers in the Iranian market will increase. As mentioned above, the administration has already started to sign deals with French car makers. PSA Peugeot Citroen seems to be the first beneficiary in Iran, as it has been present in the market for a long time. Peugeot withdrew from Iran in 2012, due to international sanctions. However Khodro continued to produce vehicles under the Peugeot-brand. Iran was the second biggest market for the French car producer, after France.

Another French manufacturer, Renault SA which suspended its business in Iran in 2013 following stricter sanctions, was able to maintain the manufacturing process in Iran although the volume of production and sales were low. The company announced, during a press conference in Tehran, in July 2015, that its first priorities in Iran are to expedite manufacturing of current models and to produce new models. Renault also plans to develop its research center in Iran.

14. Al Monitor, Iran works to get auto industry back on the road, August 2015
15. BMI, Demographic Outlook Iran, 2016

Renault Pars is a joint venture that was established between Renault and Iran's Industrial Renovation Organisation (IDRO) in 2004. Renault's car sales in Iran totalled 36,300 cars in 2014, a drop of 9% from the year before[16] . In the first ten months of 2015, sales stood at 30,030, up 7.3% compared with the same period in 2014[17] .

Other foreign car makers are also eyeing the Iranian market for new opportunities. Daimler has announced that its trucks division has signed letters of intent with joint venture partners in Iran to re-enter the market.

This influx of foreign car makers will create tough competition in the market, in terms of positioning Iranian brands. On the other hand, Iran still has many regulations in place to restrain imports. Daimler has said that it will cooperate with Iran Khodro Diesel (IKD) and Iran's Mammut Group, to establish a joint venture for local production of Mercedes-Benz trucks and powertrain components[18] .

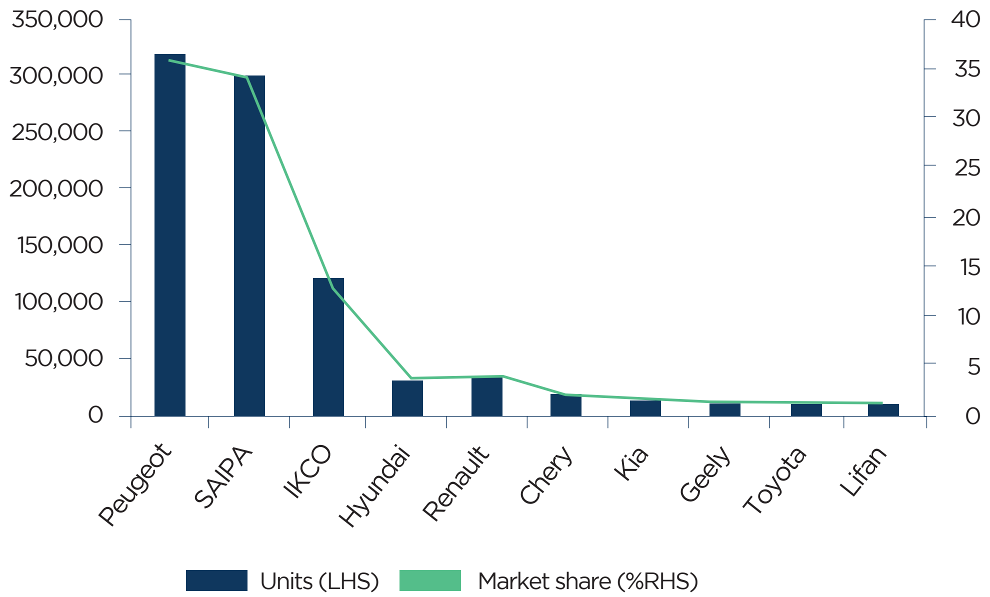
Other producers such as VW, Fiat and Skoda are also reportedly in talks to enter the market. Depending on the political and economic conditions, vehicle supplies to Iran may increase in the upcoming period, through new joint ventures.

The arrival of new manufacturing brands could make it difficult for the companies already present to maintain their market share. This could be the case for Chinese producers if European car makers manage to provide vehicles to the market which are cheaper and of higher quality. Indeed, Western sanctions have allowed brands such as Chery and Lifan to increase their exposure in Iran, as they were not covered by restrictions. Chery initiated cooperations with Modiran Vehicle Manufacturing Company (MVM) in Iran, early in 2004. Over the last 12 years, it has become one of the largest auto manufacturers in Iran, with sales of nearly 40,000 units in both 2014 and 2015.

3 Conclusion

The lifting of sanctions marks the beginning of a new era for Iran. Growth will record a significant uptick on the back of skyrocketing foreign investments and a recovery in private consumption, with lower inflationary pressures. Yet some challenges will continue to restrain growth over the coming period. Some of these challenges are technical such as Iran's current tariffs policy, regulatory constraints and bureaucratic inflexibility that could limit trade growth. Other challenges are more related to structural issues, such as the existence of dual exchange rates, the lack of competitiveness and the lack of investments over the past decade. In addition, the sustained decline in oil prices will weigh on exports. The lifting of sanctions should allow an increase in the production of hydrocarbons but it could be constrained by the poor prospects of the oil market. The Iranian administration is also focusing on reviving the automotive sector, which accounts for more than 10% of GDP. Higher growth perspectives are positive for this sector, although the competition will be tough for car makers.

Graph 9: Iran car sales by brand (2014)



Source: BMI

16. Tehran Times, Renault Never Left Iran During Sanctions, August 2015
17. Tehran Times, Renault's One-Month Sales to Iran up 2.5 folds yr/yr, November 2015
18. Reuters, Truck maker Daimler signs agreement to return to Iran, January 2016

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