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Don't Buy the Spin: Iran is Getting Economic Relief

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Foreword by Mark Dubowitz and Annie Fixler[1]

In recent weeks, U.S. Secretary of State John Kerry has been on an international "road show"[2] to encourage large European banks to return to business with Iran and to help alleviate their concerns about the legal risks associated with engaging with a country still under U.S. sanctions for money laundering, terrorism, missile proliferation, and human rights abuses. These banks also are concerned about the extensive level of non-performing assets and about financial transactions involving the still-sanctioned Islamic Revolutionary Guard Corps, which is dominant in the most lucrative sectors of Iran's economy through its control of thousands of front companies.

Meanwhile, members of Congress from both parties[3] are concerned that the administration is exploring workarounds to allow Iran to "dollarize" transactions without directly accessing the U.S. financial system.[4] These workarounds include allowing foreign financial institutions to enable dollarized transactions on Iran's behalf using offshore clearing, intra-bank book transfers and conversions, or similar dollar-based mechanisms.[5] Providing

1. This analysis is coauthored by 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 United States 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 and sanctions relief on Iran's economy can help inform policy choices.
2. David Brunnstrom, "Kerry seeks to soothe European bank nerves over Iran trade," *Reuters*, May 12, 2016. (http://www.reuters.com/article/us-iran-banks-kerry-idUSKCN0Y30OJ); Felicia Schwartz, "Kerry Tries to Drum Up Some Business in Europe for Iran," *The Wall Street Journal*, May 10, 2016. (http://www.wsj.com/articles/kerry-tries-to-drum-up-some-business-in-europe-for-iran-1462902185)
3. "Members of Congress Voice Opposition to Allowing Iran Access to U.S. Dollar," *AIPAC News Hub*, April 14, 2016. (http://www.aipac.org/news-hub?id=%7BD2718745-DE47-4551-B89B-457170146D16%7D#)
4. "New U.S. sanctions concession to Iran may be in works: AP," *Associated Press*, March 31, 2016. (http://www.cbsnews.com/news/new-us-sanctions-concession-to-iran-may-be-in-works-ap/)
5. Eric B. Lorber, "Treasury Prepares to Take Dollarized Transactions with Iran," *Foundation for Defense of Democracies*, March 31, 2016. (http://www.defenddemocracy.org/media-hit/eric-b-lorber-treasury-prepares-to-take-dollarized-transactions-with-iran-offshore/); Katerine Bauer, "Potential U.S. Clarification of Financial Sanctions Regulations," *The Washington Institute for Near East Policy*, April 5, 2016. (http://www.washingtoninstitute.org/policy-analysis/view/potential-u.s.-clarification-of-financial-sanctions-regulations); Patricia Zangerle, "UPDATE 1-Ryan urges Obama to rule out sanctions 'workarounds' for Iran," *Reuters*, April 18, 2016. (http://www.reuters.com/article/iran-nuclear-usa-congress-idUSL2N17L14Z)

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this additional sanctions relief would contradict repeated administration statements[6] and goes beyond any commitments made to Iran under the nuclear agreement.

Meanwhile, international banks aren't taking the bait.[7] Notably, HSBC Chief Legal Officer and former Treasury Under Secretary Stuart Levey stated that the decisions of his bank are "driven by the financial-crime risks and the underlying conduct" and there have been no assurances that Iran's government has addressed the illicit conduct on which the sanctions were based.[8] Indeed, the International Monetary Fund (IMF)'s David Lipton noted on a visit to Tehran that "The best thing the government can do, and the banks can do, is to bring those standards up to international levels and try to reassure foreign partners, banks and otherwise that Iran's banks are safe to deal with."[9] Former Treasury spokesperson Hagar Hajjar Chemali similarly noted, "The only move that could help bring on the business is for Tehran to change its foreign policy and improve its financial transparency measures."[10]

As this report demonstrates, even without access to dollarized transactions or the implementation of economic reforms, Tehran has already received a major "stimulus package" in the form of sanctions relief. Indeed, Iran has brought oil to market more quickly than expected by drawing down its inventories, accessed imports, and stabilized the economy.

This is a major shift. In 2012 and 2013, Iran's economy was crashing. It had been hit with an asymmetric shock from sanctions, including those targeting its central bank, oil exports, and access to the SWIFT financial messaging system.[11] The economy shrank by more than six percent in the 2012/13 fiscal year, largely due to the drop in oil exports and revenue because of tightening sanctions, and bottomed out the following year, contracting by another two percent.[12] Accessible foreign exchange reserves were estimated to be down to only $20 billion, limiting imports.[13]

6. Jacob Lew, "Written Testimony of the Secretary of the Treasury," *Hearing before the Senate Foreign Relations Committee*, July 23, 2015. (http://www.foreign.senate.gov/imo/media/doc/07-23-15%20Lew%20Testimony.pdf); Jacob Lew, "Written Testimony of the Secretary of the Treasury," *Hearing before House Foreign Affairs Committee*, July 28, 2016. (http://docs.house.gov/meetings/FA/FA00/20150728/103823/HHRG-114-FA00-Wstate-LewJ-20150728.pdf); Adam Szubin, "Written Testimony," *Hearing before the Senate Banking, Housing, and Urban Affairs Committee*, August 5, 2015. (https://www.treasury.gov/press-center/press-releases/Pages/jl0144.aspx); Adam Szubin, "Beyond the Vote: Implications for the Sanctions Regime on Iran," *Keynote Address before The Washington Institute for Near East Policy*, September 16, 2015. (http://www.washingtoninstitute.org/uploads/Documents/other/SzubinTranscript20150916-v2.pdf)
7. Martin Arnold, Geoff Dyer, and Najmeh Bozorgmehr, "European banks resist calls to increase business ties with Iran," *Financial Times,* May 12, 2016. (http://www.ft.com/intl/cms/s/0/acae21f2-1796-11e6-bb7d-ee563a5a1cc1.html)
8. Stuart Levey, "Kerry's Peculiar Message About Iran for European Banks," *The Wall Street Journal*, May 12, 2016. (http://www.wsj.com/articles/kerrys-peculiar-message-about-iran-for-european-banks-1463093348)
9. Golnar Motevalli, "Iran Must Fix Own Banks to Win Overseas Business, IMF Says," *Bloomberg*, May 17, 2016. (http://www.bloomberg.com/news/articles/2016-05-17/iran-must-fix-own-banks-to-win-business-from-overseas-imf-says)
10. Hagar Hajjar Chemali, "If Iran Wants Business, It's Up to Iran to Change," *The Huffington Post*, May 15, 2016. (http://www.huffingtonpost.com/entry/if-iran-wants-business-its-up-to-iran-to-change_us_57392bbfe4b06dede18b941c)
11. National Defense Authorization Act For Fiscal Year 2012, Pub. L. 112-81, U.S.C. § 1245. (https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ndaa_publaw.pdf); Iran Threat Reduction and Syria Human Rights Act of 2012, 112 U.S.C. § 202. (https://www.treasury.gov/resource-center/sanctions/Documents/hr_1905_pl_112_158.pdf); SWIFT, Press Release, "SWIFT instructed to disconnect sanctioned Iranian banks following EU Council decision," March 15, 2012. (https://www.swift.com/insights/press-releases/swift-instructed-to-disconnect-sanctioned-iranian-banks-following-eu-council-decision)
12. Mark Dubowitz, Annie Fixler, and Rachel Ziemba, "Iran's Economic Resilience Against Snapback Sanctions Will Grow Over Time," *Foundation for Defense of Democracies and Roubini Global Economics*, June 2015. (http://www.defenddemocracy.org/content/uploads/publications/Iran_economy_resilience_against_snapback_sanctions.pdf)
13. Mark Dubowitz and Rachel Ziemba, "When Will Iran Run Out of Money?" *Foundation for Defense of Democracies and Roubini Global Economics*, October 2, 2013. (http://www.defenddemocracy.org/content/uploads/documents/Iran_Report_Final_2.pdf)

This changed during the nuclear negotiations, as previous reports from Roubini Global Economics and the Foundation for Defense of Democracies have detailed. During the 18-month period starting in late 2013, interim sanctions relief[14] and the lack of new shocks enabled Iran to move from a severe recession to a modest recovery.[15] During that time, the Islamic Republic received $11.9 billion through the release of its restricted assets, while sanctions on major sectors of its economy were suspended. This facilitated strong imports, especially from China, that in turn supported domestic investment. The Obama administration also de-escalated the sanctions pressure by blocking new legislation that would have maintained or tightened sanctions on oil-related and other economic transactions.[16] Jointly, these forces rescued the Iranian economy and its leaders, including the Revolutionary Guards, from an imminent and severe balance of payments crisis. As this report finds, in the 2014/15 fiscal year, the Iranian economy rebounded and grew at a rate of at least 3 percent.

Now, under the Joint Comprehensive Plan of Action (JCPOA), Iran has received access to an additional $100 billion in previously frozen foreign assets, significantly boosting its accessible foreign exchange reserves.[17] As we described in our previous reporting on this topic,[18] while Iran has access to $50-60 billion in liquid assets, its total funds are closer to $100 billion. Excluding previously allocated funds from this total fails to adequately estimate the effect of releasing previously frozen assets on the economy. Some of these allocated funds are collateral for joint ventures or deposits for imports. Thus, while these funds are unavailable for new investments, the payoff from the previous allocations will positively impact the Iranian economy.

Sanctions were also lifted on Iran's crude oil exports and upstream energy investment and on key sectors of the economy and hundreds of Iranian banks, companies, individuals, and government entities. The additional access of Iranian institutions to global financial payments systems, such as SWIFT, has reduced transaction costs and the need for intermediaries.

This report demonstrates that in the fiscal year that has just ended – with declining oil prices, a tight monetary policy implemented to rein in inflation, and a tight fiscal policy imposed given revenue shortfalls – Iran's economy grew only slightly, and may have even experienced a modest contraction.[19] But in the coming fiscal year, Roubini

14. U.S. Department of the Treasury, "Frequently Asked Questions Relating to the Extension of Temporary Sanctions Relief through June 30, 2015, to Implement the Joint Plan of Action between the P5 + 1 and the Islamic Republic of Iran," November 25, 2014. (https://www.treasury.gov/resource-center/sanctions/Programs/Documents/jpoa_ext_faq_11252014.pdf)
15. Mark Dubowitz and Rachel Ziemba, "Early Signs of an Iranian Economic Recovery," *Foundation for Defense of Democracies*, January 9, 2016. (http://www.defenddemocracy.org/media-hit/early-signs-of-an-iranian-economic-recovery/); Jennifer Hsieh, Rachel Ziemba, and Mark Dubowitz, "Iran's Economy: Out of the Red, Slowly Growing," *Foundation for Defense of Democracies and Roubini Global Economics*, October 2014. (http://www.defenddemocracy.org/content/uploads/publications/RoubiniFDDReport_Oct14.pdf); Jennifer Hsieh, Rachel Ziemba, and Mark Dubowitz, "Iran's Economy Will Slow but Continue to Grow Under Cheaper Oil and Current Sanctions," *Foundation for Defense of Democracies and Roubini Global Economics*, February 2015. (http://www.defenddemocracy.org/content/uploads/publications/RoubiniFDDReport_FEB15.pdf)
16. Mark Landler, "Senate Bill to Impose New Sanctions on Iran Spurs Veto Threat From White House," *The New York Times*, December 19, 2013. (http://www.nytimes.com/2013/12/20/world/middleeast/senate-bill-to-impose-new-sanctions-on-iran-spurs-veto-threat-from-white-house.html?_r=1)
17. Brian Murphy, "Iran claims $100 billion now freed in major step as sanctions roll back," *The Washington Post*, February 1, 2016. (https://www.washingtonpost.com/world/iran-claims-100-billion-now-freed-in-major-step-as-sanctions-roll-back/2016/02/01/edfc23ca-c8e5-11e5-a7b2-5a2f824b02c9_story.html); Adam Szubin, "Written Testimony," *Senate Committee on Banking, Housing, And Urban Affairs*, August 5, 2015. (https://www.treasury.gov/press-center/press-releases/Pages/jl0144.aspx)
18. Mark Dubowitz, Annie Fixler, and Rachel Ziemba, "Iran's Mysterious Shrinking Reserves: Estimating the Value of Tehran's Foreign Assets," *Foundation for Defense of Democracies and Roubini Global Economics*, September 2015. (http://www.defenddemocracy.org/content/uploads/publications/FDDRoubini_Report_Irans_mysterious_shrinking_reserves.pdf)
19. Saeed Ghasseminejad, "Rouhani's abysmal economic record and the West's dilemma," *Business Insider*, March 30, 2016. (http://

Global Economics projects that Iran's economy will grow at a rate of 3.7 percent. Assuming that Iran continues to make modest economic reforms to attract investment, this report forecasts its economic growth will stabilize around 4 to 4.5 percent annually or higher over the next five years.

The future success of Iran's economy depends on privatization, encouraging competition, addressing corruption, recapitalizing banks, and strengthening the rule of law. If Tehran wants to encourage foreign investment and alleviate international banks' concerns, it also needs to end its support for terrorism, missile development, and destabilizing regional activities, and to reduce the economic power of the Revolutionary Guards and the supreme leader's business empire. All of these factors increase the risks of investing in the Islamic Republic, regardless of what deal-sweeteners the White House provides.

Summary

- This report updates our macroeconomic forecasts for Iran, with a focus on the impacts of sanctions relief in the last several months. After effectively no growth in FY 2015/16 which ended in March, oil exports are picking up, and there are signs the overall economy will follow. With oil prices now on the rise, export volumes increasing, and some increase in imports, Iranian domestic demand should accelerate in FY 2016/17 to a pace of around 3%, reaching an overall growth pace of 4-5 percent in FY 2017/18 if Iranian authorities hold to their planned implementation. Maintaining or increasing this level of growth would require domestic economic reforms and strong implementation of policies to attract investment such as those outlined in recent IMF speeches.

- **2015 was weak:** Lower oil prices, faltering demand, tight fiscal and monetary policy, and uncertainty about the implementation of sanctions relief suggest that Iran's economic growth remained modest in the 2015/16 fiscal year. We estimate that the economy barely grew in the last fiscal year (ending March 20, 2016) and may indeed have contracted modestly as the authorities focused on restraining inflation and adjusting to lower oil prices.

- **Oil exports bounce back:** In FY 2016/17, Iran's economy looks set to re-accelerate as domestic investment and oil exports pick up. As of Q2 2016, Iran's oil exports rose by 500-600,000 barrels per day (close to early 2012 levels) and production rose by 250-300,000 barrels per day. Sizeable foreign investment in the energy sector will likely occur only after 2017 or 2018, given ongoing contract discussions and domestic implementation issues.

- **Domestic policy implementation matters:** External factors, including the price of and demand for oil, will constrain economic activity. However, domestic policy choices around implementation of the nuclear deal, as well as other economic policy priorities, will be more important for the pace and composition of growth in the short-to-medium term.

- **Recent election results** suggest Iran's parliament is broadly supportive of President Rouhani's fiscal policy and general economic reform path; however, recent statements by Supreme Leader Ali Khamenei questioning the extent of sanctions relief delivered under the JCPOA, the election of hardliner Ayatollah

www.businessinsider.com/rouhanis-abysmal-economic-record-and-the-wests-dilemma-2016-3); International Monetary Fund, "Iran Faces Multiple Challenges as Growth Prospects Brighten," *IMF Survey*, January 20, 2016. (http://www.imf.org/external/pubs/ft/survey/so/2016/new012016a.htm)

Ahmad Jannati as head of the Assembly of Experts, and the re-election of hardliner Ali Larijani as speaker of the parliament could spell trouble ahead for Rouhani's agenda. There also are significant implementation challenges from other actors. We have yet to see major measures that would reduce the role of vested interests (such as the Islamic Revolutionary Guard Corps) in the economy.

- **Weak business environment**: Iran continues to have one of the world's weakest business environments as measured by RGE's Country risk scoring system, with investment held back by red tape and banks burdened by high levels of non-performing assets, leaving them ill-equipped to provide financing to the domestic economy. Addressing these issues at home and responding to increased global competition will be key to attracting investment and sustainable growth.

- **Although Iran looks more resilient** than some of its oil-exporting peers in the Middle East and Africa, low oil revenues will still be painful for the economy. Policy moves (including currency and fiscal adjustment) and an increase in non-oil exports have allowed the country to partly adapt to the fall in oil prices. In the current fiscal year, we expect some further depreciation of the rial versus the USD, but a stronger oil price would allow the government to temper draconian fiscal cuts.

Figure 1: Summary of Key Economic Indicators

		2011/12	2012/13	2013/14	2014/15	2015/16(f)	2016/17(f)	2017/18(f)
		Aggregate						
Real GDP	Growth (%)	3.75%	-6.61%	-1.91%	3.34%	0.70%	3.70%	4.30%
Real Total Consumption	Growth (%)	3.37%	-2.56%	-0.62%	3.05%	3.06%	3.17%	3.50%
CPI Inflation	Average	21%	31%	35%	16%	12%	10%	13%
Exchange Rate (IRR/USD, eop)	Official	11,023	12,260	21,614	26,590	29,631	31,892	32500
	Unofficial/ Black Market	14,214	26,630	31,833	32,929	34,050	40,000	38,000
		Per Capita						
(2011=100)	Real GDP	100	93.4	91.6	95.6	96.3	100.9	103.927
	Total Consumption	100	97.4	96.8	99.8	102.8	106.1	109.8135

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

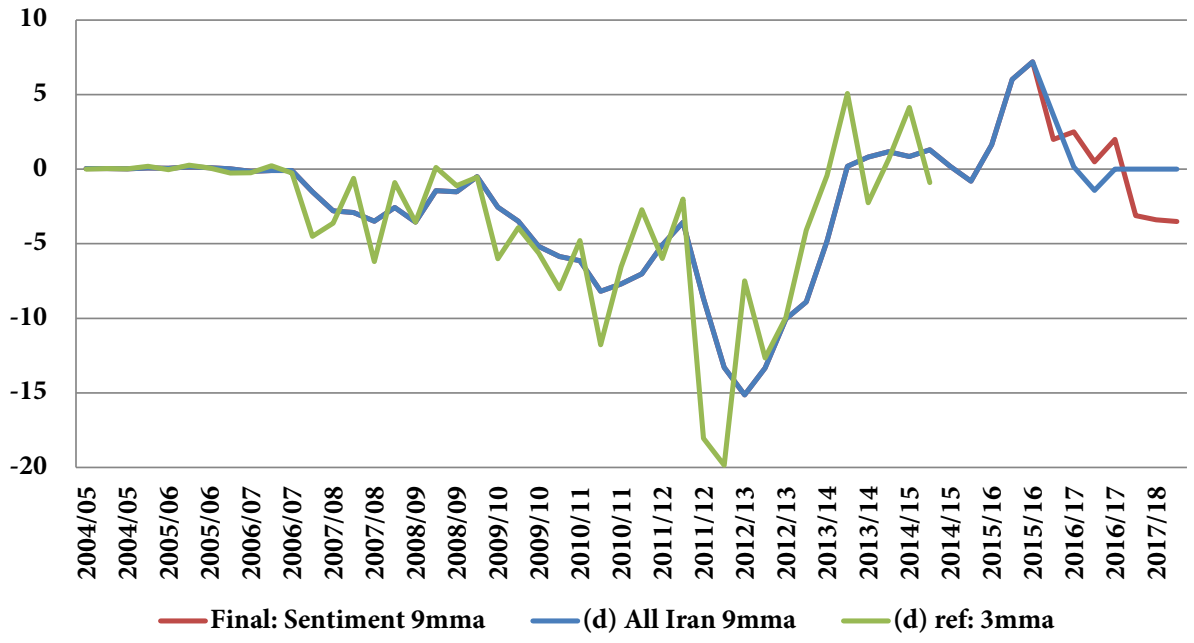
Economic Activity Based on Oil and Investment

Sanctions relief following the implementation of the Joint Comprehensive Plan of Action (JCPOA) has helped stabilize Iran's economy and set the tone for a modest acceleration in GDP growth. The major drivers of growth

in 2016 will be oil exports, even though low prices will hit revenue, along with a likely increase in foreign direct investment (FDI). Iran's economic growth will rebound to close to 4 percent in the current fiscal year (which began in March). Tight fiscal and monetary policy will limit the acceleration of economic activity as Iranian authorities focus on keeping inflation at bay; any delay in implementing investment-oriented policies will also stifle growth. As a result of these domestic economic policies, the balance of risks is tilted toward a weaker pace of growth (closer to 3 percent), with a more meaningful acceleration set to take place after 2017, with investment, trade, and capital all giving rise to a virtuous circle.

Consumption remains a major driver of growth, supported by modest improvements in consumer sentiment and asset prices over the last year. A combination of weak growth and low oil prices has weighed on domestic sentiment. We expect some of these trends will begin or continue to improve in FY 2016/17, based on stronger oil prices and export volumes, which facilitate less government austerity and a rally in local assets. Together these suggest that domestic sentiment, which leads GDP, should start to improve.

Figure 2: After an Improvement, Domestic Economic Sentiment has Stalled



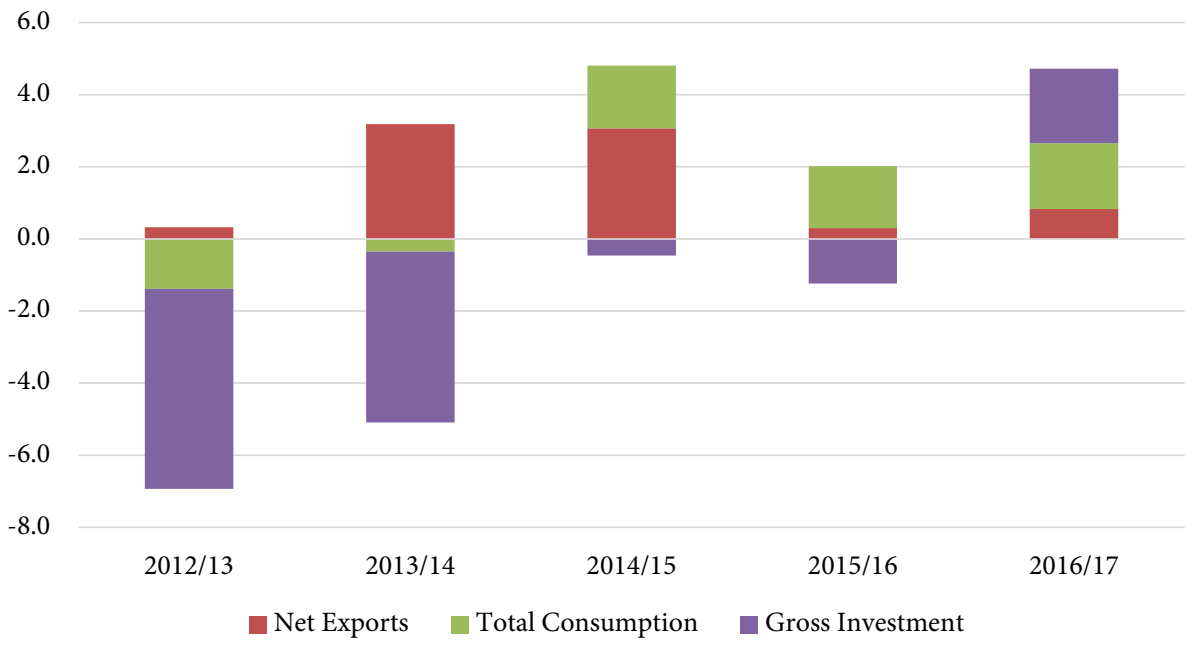
Source: Ravenpack, Roubini Global Economics.

Note: Our sentiment indicator measures local and global press reports for a measure of sentiment of domestic actors and foreign investors in Iran. As a diffusion indicator, measures above 0 indicate positive sentiment; measures below 0 reflect a significant decline in sentiment. This sentiment indicator tends to move in sync with the Iranian rial and lead GDP by 1-2 quarters.

Sectors benefiting from sanctions relief, notably energy and manufacturing, will drive growth in the current fiscal year. A key sector benefiting from sanctions relief and stronger domestic demand is the auto sector. Although most cars and many car parts are imported, the restart of the country's labor-intensive auto industry has added jobs in the last two years and enabled Iranians to purchase cheaper domestically produced cars (versus the previously available and highly taxed imports). Restrained credit, wages, and government spending, however, will limit the increase in domestic consumption.

Other sectors that were not directly sanctioned, such as agriculture, but suffered from lack of access to local and global financing are likely to benefit from the reduction in transaction costs. Iran's ability to take greater advantage of sanctions relief will depend not only on the implementation of the deal and access to financial channels but also on the government's implementation of other reforms that help attract foreign investment.

Figure 3: Net Exports Become Growth Driver Again in 2016 (contributions to GDP growth, percentage points)



Source: Central Bank of Iran and Roubini Global Economics

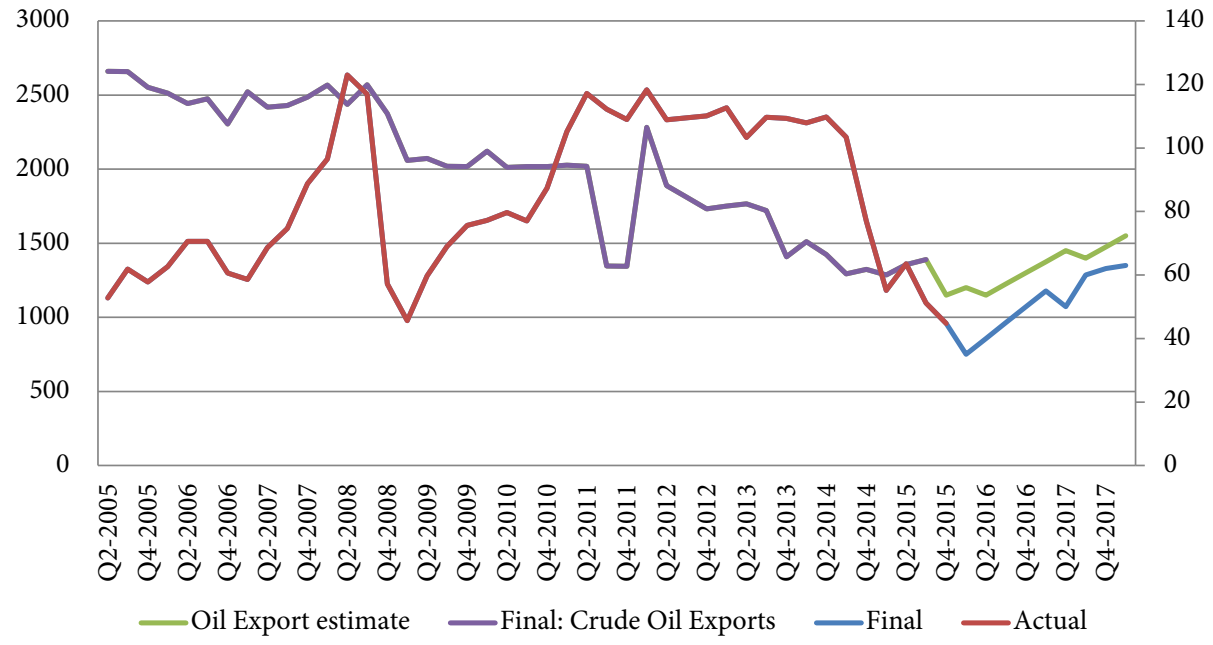
In FY 2017/18, fixed investment will begin to pick up, although services and consumption will continue to be major sources of demand.

Energy Sector

Sanctions relief has begun to unlock oil exports, allowing Iran to begin selling off some of the surplus oil and oil products that have been building up in floating storage. So far, Iran has been able to increase exports by around 500,000 barrels per day (bdp), according to IEA and EIA statistics, though local production has risen by only about a third of this level. This suggests that oil exports are approaching their early 2012 trend, and production may near 2012 levels (3.6 million bdp) by year-end.

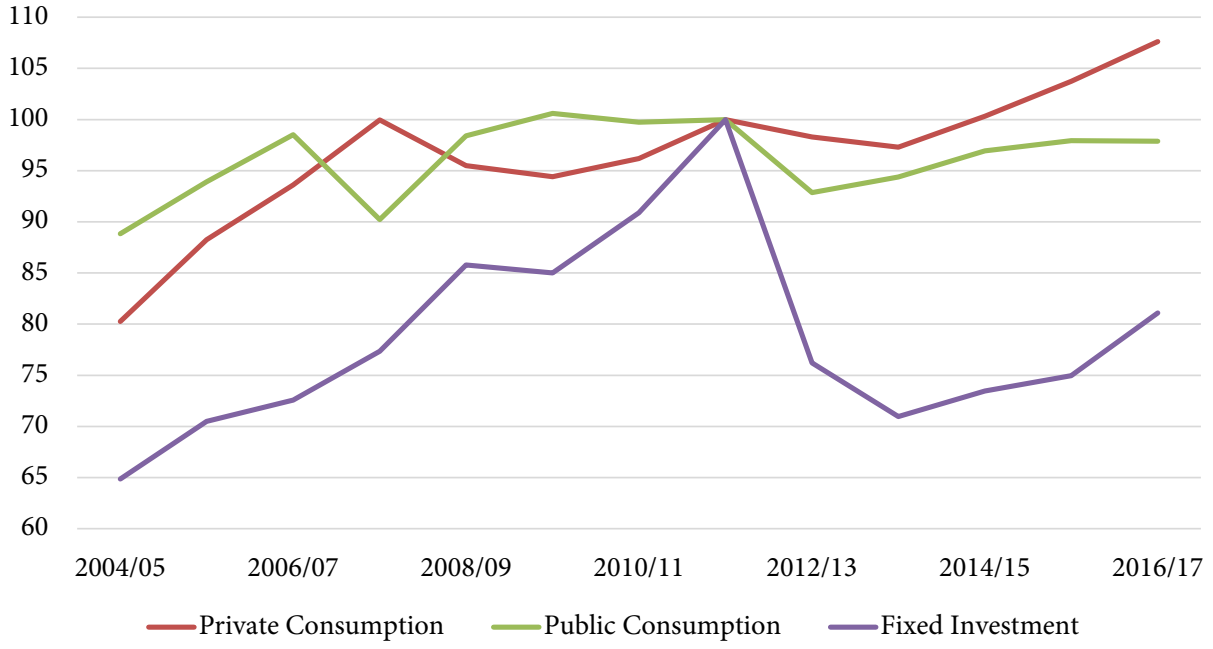
Public data suggest Iran has signed new contracts consistent with additional supplies of up to 400,000 barrels per day with European (Switzerland and parts of Southern Europe) and Asian buyers (India, Korea, and China). Most of the initial increase in export volumes was shipped to East and South Asia and may be based off of spot cargos.

Figure 4: Oil Export Volumes and Prices to Rise Slowly



Source: Haver Analytics, Roubini Global Economics

Figure 5: Pickup in Energy Production/Investment Likely to Lag



Source: Haver Analytics, Roubini Global Economics

Lower oil prices, compared with the 2014 and 2015 annual averages, in part a function of an expected increase in Iranian output, limit Tehran's additional capacity to generate cash. With oil prices hovering around $40 per barrel, Iran would have to sell 7.5 million bpd to generate the same income as it did in 2011, when it sold 2.5 million bpd in the absence of sanctions.[20] Even at a price of $50 per barrel, revenues will fall short of historical trends, suggesting that the government will have little scope to increase investments. As a result, it will need to rely on attracting foreign capital to finance those investments.

Although the increase in export volumes from Iran is likely to weigh on global oil fundamentals in the near term by exacerbating oversupply, fundamentals are likely to tighten as 2017 approaches. There is an assumption that other OPEC countries (particularly Saudi Arabia) will largely keep production flat this year and that U.S. and Western Hemisphere production will fall, while demand for crude oil will barely grow at a rate slightly weaker than the IEA estimates. Reducing the oil-market surplus (as signaled by a reversal in U.S. commercial oil inventories) may not happen until early 2017.

Iran's energy investment will only pick up meaningfully after new oil contracts are signed given the importance of oil-sector expertise to increased production. Iranian authorities have faced recurrent delays in presenting, let alone signing, any contracts for future investment. Foreign counterparts have commented that Iranian authorities fail to understand the competition in the sector and have yet to fully adjust to the lower oil price environment.

New foreign partnership and expertise is key for energy sector development. Many energy experts suggest that the Chinese companies already partnering with Iran lack the needed expertise to take on new projects. Moreover, Iranian authorities have signaled that their Chinese partners are a second-best choice. Although many international oil companies have been exploring possible operations in the country, Iranian authorities have yet to present contract terms. Moreover, gridlock within the parliament suggests each contract might have to be approved separately, raising significant implementation risk. As a result, oil-sector investment stemming from new projects and new exploration contracts is only likely to be a significant factor in Iran's economy in 2018 or later.

Natural gas may lead oil: New investment could flow more quickly into natural gas than oil, as has been the case over the last several years. An increase in natural gas production would help meet domestic demand and reduce imports while generating inputs that could be used in petrochemicals, eventually leading to higher exports. Natural gas and petrochemicals are likely to be more meaningful than oil exports, with petrochemical production a key focus of domestic economic development. Iranian authorities may be reluctant to sell natural gas at market price at home, but many of Iran's agreements for foreign natural gas sales seem to be politically motivated, involving neighbors like Iraq, Oman, and Pakistan – all countries that may struggle to pay global natural gas prices.

20. U.S. Energy Information Administration, "Sanctions reduced Iran's oil exports and revenues in 2012," April 26, 2013. (http://www.eia.gov/todayinenergy/detail.cfm?id=11011)

Iran's FX Reserves and the Rial

Iranian authorities and their U.S. counterparts have signaled that FX reserves and foreign liquidity available to finance imports stand at close to $50-60 billion with Iran's frozen assets now accessible as part of JCPOA sanctions relief totaling about $100 billion.[21] The difference represents previously allocated funds and others that were in loss-making or non-performing assets. As we described in our previous reporting on this topic,[22] excluding previously allocated funds from this total fails to adequately estimate the effect of releasing previously frozen assets on the economy. Some of these allocated funds are collateral for joint ventures or deposits for imports. Thus, while the funds are unavailable for new investments, the payoff from the previous allocations will positively impact the Iranian economy.

Some of the liquid assets can be used as collateral or to finance imports of consumer or investment goods, while others will be spent. Should Iranian authorities be unwilling to use these funds, either because they have been already allocated as collateral in investment projects or because they are being held in reserve for future currency management, Iran's imports and domestic fixed investment in the petrochemical, automotive, and construction sectors would be even more tied to its ability to attract foreign portfolio and direct investment. We expect that FX reserves will be flat in FY 2016/17 and rise only slowly in FY 2017/18 as Iran runs a small trade surplus and a government deficit.

The rial will likely continue to depreciate from current levels as official rates align with market rates, resulting in a slight increase in inflation in the second half of the year to a pace close to 10 percent.

We expect the official rate to move toward 32,000 rials per USD and the gap between the official and black market rates to converge (Figure 6) – a reform that Iranian authorities have committed to and the IMF has sanctioned. A combination of stronger food prices and a weaker rial will boost inflation slightly in 2017.

Iranian Government Policy Will Determine Growth Path

Domestic monetary and fiscal policy will be critical in determining growth in the next few quarters and years, either amplifying or undermining the impact of sanctions relief. Both fiscal and monetary policy have been a drag on economic growth for the last two years, as they focused on reducing inflation and adjusting to lower oil prices. We expect this trend will continue. Tight monetary policy (higher interest rates) brought weak lending growth, putting additional pressure on private sector investment. The Rouhani administration has signaled a continued preference for tight economic policy (high interest rates and fiscal austerity) to avoid a recurrence of inflation, but this will come at the expense of growth.

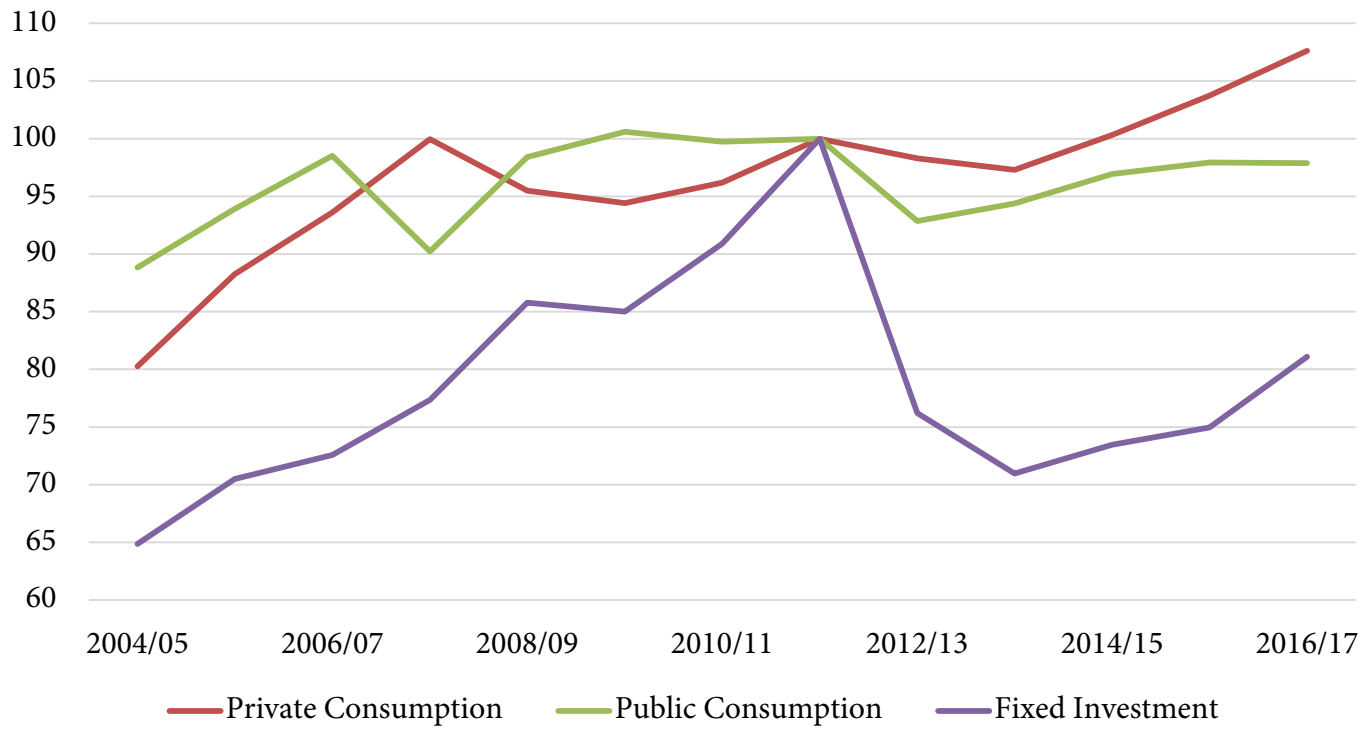
The recent Majlis elections do not seem likely to change these policy preferences. For now, this policy of tighter government spending seems to be generally supported by the conservatives in the Majlis. As low oil prices leave little space for government spending, Iran's economy will need to attract international direct inflows of capital to support investment and any related imports.

21. Mark Dubowitz, Annie Fixler, and Rachel Ziemba, "Iran's Mysterious Shrinking Reserves: Estimating the Value of Tehran's Foreign Assets," *Foundation for Defense of Democracies and Roubini Global Economics*, September 2015. (http://www.defenddemocracy.org/content/uploads/publications/FDDRoubini_Report_Irans_mysterious_shrinking_reserves.pdf)
22. Mark Dubowitz, Annie Fixler, and Rachel Ziemba, "Iran's Mysterious Shrinking Reserves: Estimating the Value of Tehran's Foreign Assets," *Foundation for Defense of Democracies and Roubini Global Economics*, September 2015. (http://www.defenddemocracy.org/content/uploads/publications/FDDRoubini_Report_Irans_mysterious_shrinking_reserves.pdf)

In our baseline scenario, we assume that economic policy, particularly fiscal, will remain tight for the first few quarters of FY 2016/17. Additional spending may be launched ahead of the next presidential election (scheduled for the spring of 2017) as the government tries to highlight some of the benefits delivered by recent policy moves.

Iran's banks are ill-equipped to support domestic demand and investment. Credit growth is likely to remain restrained, as sizeable non-performing loans will impair Iran's capacity to extend credit. Government borrowing has increased, increasing the risk that Iranian banks will have little willingness and ability to lend to the private sector. Global banks, particularly European ones, remain much more cautious about investing in Iran than are their peers in the corporate sector. This caution reflects concerns about the implementation of sanctions relief and, more importantly, counterparty risk vis-à-vis Iranian banks, which continue to suffer from extensive risks around money laundering, terror and missile financing, and sanctions evasion as well as the dominance of the still-sanctioned Revolutionary Guards in Iran's economy.

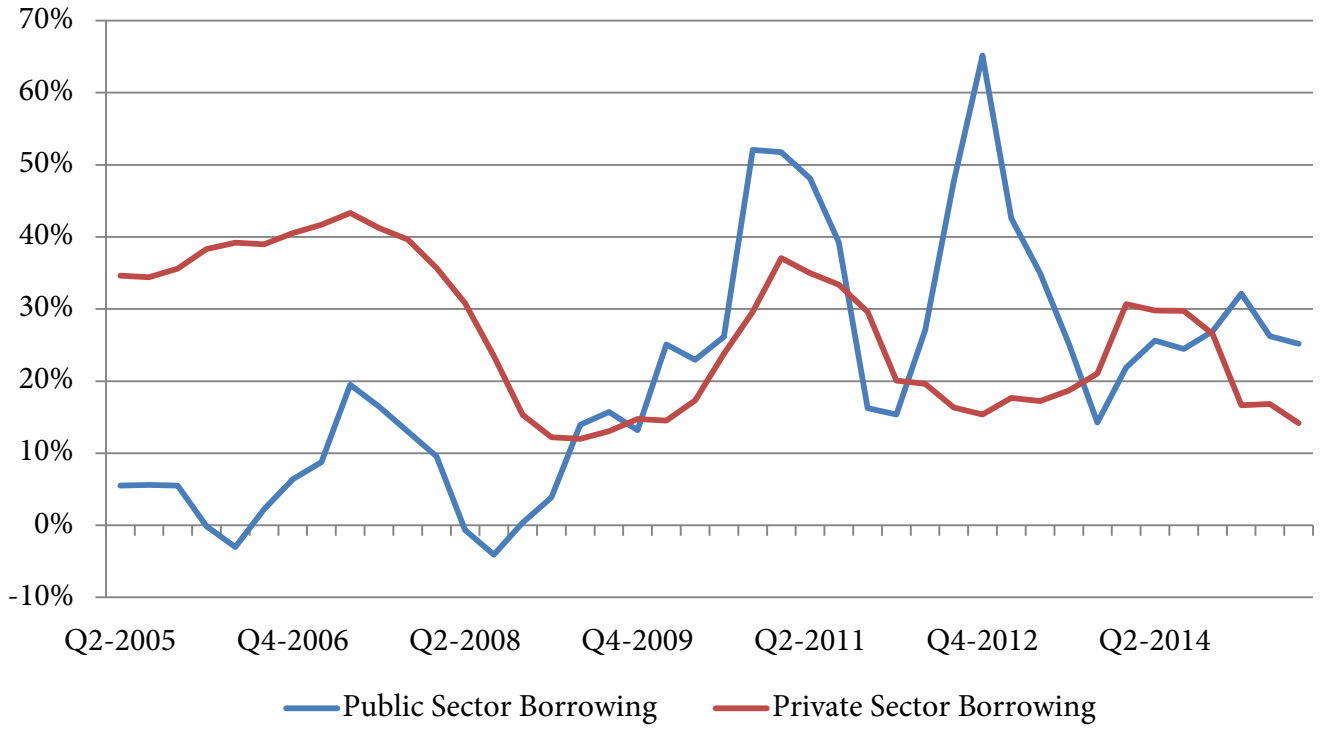
Figure 6: Inflation Remains Subdued Due in Part to Tight Monetary Policy



Source: Haver Analytics, Roubini Global Economics

Should the government increase spending or allow for more directed lending to public projects from the banks (impairing their balance sheets), economic growth and inflation might outstrip our baseline. Small businesses and individuals will continue to struggle to attract credit given the banks' concerns about asset quality, pre-existing non-performing loans already on their balance sheets, and questionable collateral. Instead any increase in credit might be focused on key development projects and manufacturing.

Figure 7: Private Sector Credit Continues to Decelerate as Government Absorbs Credit (y/y %)



Source: Haver Analytics, Roubini Global Economics

Consensus View: Iran's Economy Poised for Strong Upswing

International financial institutions such as the IMF and, belatedly, the World Bank[23] anticipate a sharp increase in economic activity in the 2016/17 fiscal year or the 2016 calendar year as sanctions are lifted and oil output increases; their growth-rate estimates are similar to or slightly higher than our forecasts. This view is generally shared by private-sector forecasters, including those investment banks that provide forecasts, with growth projections generally in the range of 3-5 percent. The World Bank currently has the most optimistic forecast, projecting a 6 percent surge in economic activity in 2016. In its view, this reflects a sharp increase in oil output and investment, based on a 500-700,000 bpd increase in oil exports over the course of 2016. Although the Bank's estimate of oil output is similar to consensus forecasts, its overall forecast looks optimistic. Given that other drivers of growth look similar, the World Bank seems to assume quite sizeable natural gas and other investment facilitating growth. It also assumes that the unlocking of Iran's foreign reserves abroad will provide significant access to financing for imports – in excess of more conservative estimates from the United States and Iran as well as IMF expectations that we have noted in this piece and elsewhere.

23. International Monetary Fund, "IMF Country Report No. 15/349: Islamic Republic of Iran," December 2015. (http://www.imf.org/external/pubs/ft/scr/2015/cr15349.pdf); World Bank, "Global Economic Prospects: Spillovers amid Weak Growth," January 2016. (http://www.worldbank.org/content/dam/Worldbank/GEP/GEP2016a/Global-Economic-Prospects-January-2016-Spillovers-amid-weak-growth.pdf)

The IMF, in contrast, has a more realistic growth forecast for 2016 and 2017 (around 4 percent). It assumes that Iran will maintain a tight fiscal policy and that its banks will struggle to support the real economy. Moreover, the IMF emphasizes that the outlook may be constrained by the slow process of reform implementation, the need to recapitalize the banks, government spending cuts, and other issues. IMF mission teams have been active in Iran, having completed several missions and Article IV consultations over the past several years and worked with the Rouhani administration to improve fiscal monitoring. These factors give us more confidence in the IMF forecasts than those of some of its peers.

Assessing Risks to Oil Exports

The most meaningful risks to Iran's economy in the current fiscal year relate to oil output. Over a longer horizon, other factors, including financial reforms, will drive economic output. Given the importance of near-term oil supplies to economic output, we look into more detail at some of the short-term obstacles to oil production and assess how meaningful these are.

Iran has activated plans to lift production by 0.5 million bpd, but doubts have emerged over its near-term export potential given that much of Iran's national fleet is being used for storage, European buyers are experiencing difficulties obtaining insurance, and the global VLCC (very large crude carrier) market has tightened. However, insurance problems around third-party vessels are likely to be resolved and, in the meantime, exports to Iran's existing customers in Asia are likely to rise. The VLCC market is not sufficiently tight to constrain exports at this point. Thus, the gradual increase in Iranian output is likely to delay the stabilization of oil fundamentals.

However, there will be some delay before the increased volumes reach the market, even from floating storage. A substantial proportion of Iran's 36 million barrels of floating inventory, which is tying up much of the National Iranian Tanker Company (NITC) fleet, is reportedly condensate. It will take some time to place given its high sulfur content – it is a relatively specialist product with specific Asian buyers – which suggests Iran will have to sell it at a discount, something it may be unwilling to do. Freeing up the capacity is not the only hurdle as the NITC fleet does not have the requisite certifications and insurance coverage for most international ports.

Until that is resolved, as during sanctions, most exports will be on third-party vessels, the majority probably buyer-chartered. European insurers have been reluctant to insure the cargos given the persistence of U.S. direct sanctions, counterparty risk in Iran's financial sanctions, and the possibility of a snap-back in sanctions should Iran's compliance with the JCPOA slip. The International P&I (Protection and Indemnity) club has yet to confirm that it can cover shipments from Iran to European destinations – one stumbling block is that its pool for larger claims includes a U.S. member. However, given urgent demand from European buyers, there are signs that these issues are being addressed.

Consequently, Iran's exports to Asia have increased first, with European flows more likely from mid-year once the insurance issues have been resolved. Many of Iran's Asian buyers initially struggled to navigate the legal areas when the oil export waiver came into effect in mid-2012, and the governments of China, Japan, and South Korea helped out by providing sovereign insurance. Now that Iranian banks have been re-hooked to the SWIFT international payments system, some of these hurdles will be overcome.

Implications for Iran's Economy of Weaker Oil Exports

In the risk case that Iranian exports are stalled, Iran might be forced to slow the increase of production and eventually exports, which may weaken local sentiment. If Tehran fails to accelerate oil exports, oil prices might reach a near-term floor and rally somewhat. Slower growth in oil exports would weigh on investment in general and the non-oil sector in particular, but we doubt technical storage issues would have much effect on medium-term energy-investment plans. Domestic vested interests, including the Islamic Revolutionary Guard Corps and conservatives wary of yielding too much control to foreigners, are a more meaningful constraint on long-term oil and gas contracts. Slower access to foreign assets or obstacles to attracting investment due to the role of vested interests in the economy constitute downside risks.

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