Islamic Republic of Iran

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **January 21, 2016**

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With the end to sanctions agreed last week, Iran is coming in from the cold. The economy should have a strong potential but is riddled with uncertainties that may hold investors back for some time.

Country Risk Analysis

Lifting of sanctions raises the prospects for the economy: Following a deep recession after tighter sanctions were imposed in 2011 the economy has begun to recover growing at an average of 3% a year. The new lifting of all main Western sanctions agreed last week has boosted the chances of stronger growth at more than 4% on average through the rest of the decade. While economic balances are not in an alarming state at the outset, at least according to official data, the economic and financial situation could now improve further making Iran an interesting new investor target. That is provided the authorities make an determined effort to solve simmering problems of government arrears and mostly associated high levels of bad loans and general mismanagement in the formal banking system.

However, this scenario comes with certain warnings. The political system of Iran is hard to fathom for outsiders. It is reportedly littered with vested interests not least among the regime’s religious and revolutionary hardliners. They seems to have profited from the tight sanction regime of recent years and would probably loath any economic opening. The purely religious establishment may also be wary seeing more interactions with the West fearful this could undermine the “moral” foundations of the state. On the other side of the table we could soon have a Republican President who may have promised to turn back the sanctions agreement from ”day one”.

In addition, in economic terms, the opening f the country dos not come at themost opportune time. The global oil price is down and could fall further should Iran raise exports by another 0,5mbpd over the next 12 months. Already at the present low prices should they remain this low the government would run into a deep deficit of more than 6% of GDP and the external balance would turn clearly into the red prompting the need for offsetting policy measures. Also, regional tensions are simmering and in a worst case scenario could turn into a military confrontation.

For several years the sovereign has not been rated by any of the three main agencies. Its last rating from Fitch was in the BB area but our hunch is that it would at least initially come in somewhat lower today. Country risk would likely turn out slightly lower still not least taking into account the uncertainties of its banking system

Recent economic developments

End to sanctions raises hopes for recovery*:* Significant tightening of the longstanding western sanctions regime in late 2011 hitting both Iran's oil exports and financial connections with the outside world generated a deep economic crisis that saw activity fall by 9% over the following two years. Thanks to interim sanctions relief and growing sentiment following the election of the pragmatic president, Mr. Rouhani, the economy bounced back in FY2013/14 (fiscal year ending March 2014) jumping 4%, but in the current year the economy is likely to disappoint again. Growth is estimated to only 2%, weighed down by low oil prices but also expectations of further lifting of sanctions which has motivated postponing of investments and consumption.

Inflation coming down: After peaking at more than 40% in 2013 the annual rate of rampant inflation, Iran's problem for many decades, appears to have come down firmly into lower two digits annual price growth mainly because of lower food prices. In last September it had dropped to less than 12% year-on-year (yoy).

Unemployment stays high. Despite recent years' fall in activity, unemployment has not increased much but rather stayed high at more than 10%. That is much due to lower participation rate with only one in four Iranians having a job, but also rising underemployment which last year measured more than 9%. Youth unemployment is the core problem with one in four youngsters out of work.

The oil sector dominates the economy: The oil sector contributes with about a quarter of GDP but dominates half of fiscal revenues and three quarters of exports. Last year it produced about 3 million barrels per day (mbpd) of which it could export 1,2mbpd some 0,6mbpd less than estimated immediate capacity due to the sanctions regime. For the time being it has about 40mn barrels of floating storage. With some of the world's largest proven reserves at 138bn. barrels, Iran can sustain present rates of exploitation for almost 100 years. Iran also produces natural gas including for exports to Turkey.

External balances: in reasonable good shape In recent years the current account has mostly been showing solid annual surpluses, but last year fell to only 0,7% of GDP in response to softening oil prices. On the capital account, by contrast, efforts to attract foreign direct investments have been largely unsuccessful, not only because of sanctions, but also due to the unpredictable business climate and the lack of personal security for many foreign business people often targeted by the country's various security services. The FDI law of 2002, however, sets no limitations on foreign participation wherever private business is permitted. Thanks to the underlying trade surplus, reserves are highly adequate at more than $70bn. sufficient for more than one year of imports. It is unclear to which extent that number covers frozen assets due to sanctions. The central bank of Iran (CBI) estimates such assets to $33bn. but foreign observers often quote much higher numbers up to $100bn. As the country was basically cut off from global finance for several years, it has been forced to pay down foreign loans as they fell due thus reducing outstanding external debt to only $8bn, less than 2% of GDP.

Policies

Growing fiscal deficit partly financed by arrears: In FY 2014/15 the fiscal deficit rose slightly to 1,3%/GDP. That modest number, however, was measured on a cash basis. On a commitment basis the number was apparently considerably higher, meaning the gap was made up with arrears in the balance. For the present fiscal year ending next March the deficit is set to rise further to almost 4% of DP. That is largely due to weaker oil revenues but also 14% hikes of government wages perhaps modest relative to previous rates of inflation but hardly affordable to the budget. The deterioration of the budget balance is also occurring in spite of ongoing cuts to fuel subsidies and hiking of taxes, including the VAT having by now reached 9% for most goods. The non-oil deficit is hovering around 8% of GDP.

National oil and wealth funds: Unlike most other oil producers, Iran has not been able to accumulate large oil funds. The government's Oil Stabilization Fund has been depleted and with $62bn. net worth the National Wealth Fund is not very large relative to the size of the economy. Moreover, this fund is statutory not permitted to lend to the government. This has traditionally financed deficits by borrowing from local markets including banks. Because of protestations from the latter, delaying payments to suppliers has become a frequently used financing method for the government in recent years.

Subsiding price pressure facilitates monetary easing: With falling inflation real rates have become positive and prompted the CBI to cut its policy rates. It has also sought to ease the liquidity situation in the interbank market by reducing reserve requirements on banks' deposits taking. The aim is not only to support ailing banks but also to arrest declining credit growth which has dropped to an annual rate of 15%, hardly above the nominal growth of the non-oil economy.

Exchange rate policies narrowing the gap to the free market rate: Since the 50% devaluation of the Rial in 2013 to IRR 25000 per USD, the exchange rate has continued weakening thus narrowing the gap to the free market so-called "bureau rate" currently offered by curb traders and private exchange dealers at around IRR30000 to IRR35000/$. The IMF considers the latter closer to post-sanctions fundamentals which means that the official rate is still some 10-15% overvalued. The central bank hopes this narrowing of the gap eventually will bring it in a position to start a managed float of the currency.

The banking system burdened by high levels of bad loans: The banking system is characterized as undercapitalized, weak asset quality with low provisioning against losses and wanting in risk management systems. The banks' overarching problem, though, is growing non-performing loans (NPL) reportedly having reached 12% of total loan books. They are in part caused by growing government arrears to commercial companies which, in return, are not able to pay their bills to the banks. Moreover, according to the latest country report of the IMF[1] the authorities are concerned that recent health checks may reveal significantly higher NPL levels. This has prompted the CBI to mandate increased provisioning which also means that banks have been forced to maintain high interest margins, raising the opportunity for unlicensed financial institutions to encroach on banks' traditional client markets. Their growing presence in the domestic money and credit markets invokes additional worries about the stability of the financial system at large.

Structural issues: For many decades Iran's private sector has been struggling with a statist public sector. As such, the business climate exhibits contradictions reflecting

[1] Islamic Republic of Iran, 2015 Article IV Consultation, Country Report No. 15/349, December 2015, Washington DC

regulatory inconsistencies. In this context we find it sufficient to note that the World Bank's annual survey "Ease of doing business" ranks Iran number 118 from top among 189 countries. That is clearly worse than Russia and China but in the same ballpark as Brazil and India.

"Ease of doing business" 2015	
Iran	118
India	130
Brazil	116
China	84
Russia	51
Hong Kong	5

World Bank survey of 189 countries

Politics

Next month, February 26, Iranians go to the polls to elect a new national assembly and also representatives for the Assembly of Experts which appoints the Supreme Leader - the country's religious top head and ultimate arbiter. In line with past form that may unleash suppressed political tensions as already seen in the vetting process for candidates permitted to run for a seat in the Majlis (parliament) where signs are rising that the establishment has started to disqualify the political opposition en masse. It noted that the elections for the Assembly of experts might turn out the more contentious as there seems to be little consensus on whom to choose as the next supreme leader after Ali Khameny who has ruled since the late 1990s and is approaching the high age of 80 years.

Political constellations in Iran are being described as extraordinary complex and unfit for a "western" understanding of political processes along traditional left/right dividing lines. Seasoned observers rather draws fault lines between radicals and pragmatists on the one and between theocrats and republicans on the other making four distinct groups with, nevertheless, often overlapping interests and motivations.

Observers note that the apparent unpredictability of Iranian politics fluctuating between radicals and pragmatists often emanates from the supreme leader who wants to keep a certain distance from politics in Tehran – staying above the fray. For example: in the recent sanctions negotiations he first endorsed secret talks with the US beginning 2012 and subsequently their open talks two years later, but then turned around in 2015 as the talks concluded with agreement among the negotiators. This latest step has been interpreted as a precaution to hedge against any blame-game in case implementation should fail. The overarching goal of the Supreme leader has been described to safeguard the foundation of the Islamic state and consequently his own position. But in the same vein he accepts some pluralism within well-defined limits as an outlet for political tensions.

So far, there is little open opposition against these foundations and pundits warn that external pressure to change this may create a serious backlash and achieve little but the opposite.

Outlook

Last week, the UN endorsement in 2015 of the negotiations between Iran and the P5+1 received its final sign of approval as the International Atomic Energy Agency gave its nod to Iran concluding that the country had lived up to its commitments. These included sending enrich uranium to Russia for processing and dismantling the core of one of its nuclear reactors while turning off centrifuges used to enrich uranium beyond the purity needed for civilian use. The EU subsequently declared the end to sanctions introduced in recent years in response to Iran's non-compliance with its obligations as a signatory to the UN anti-proliferation protocol.

As a result, Iran is again allowed to export oil to any country and approach the global financial market at par with others including payment transactions through the SWIFT system. Iran's frozen foreign assets will also be released.

Most observers believe this will have a significant positive effect on the economy. IMF and other observers estimate that GDP growth in the next financial year FY2016/17 (ending March 2017) could accelerate to more than 5% to meet pent-up domestic demand and in response to higher oil output to the tune of 0,5mbpd to reach 3,6mbpd. Better access to the outside world, including for payments and other financial transaction, would mean a positive terms of trade effect to boost growth by up to 1 percentage point over time. The unfreezing of assets abroad would be an additional impetus for a limited time period. Beyond next year, growth will probably settle at some 4%, which is closer to long term potential.

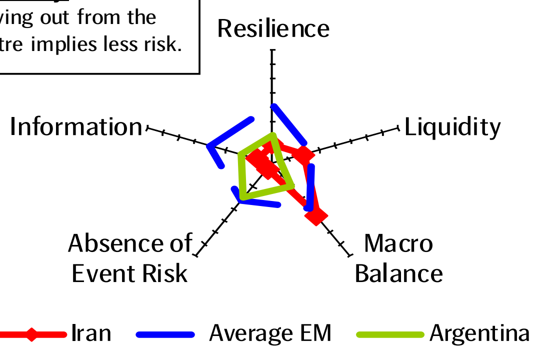
Caveats to this positive scenario include

- Renewed mistrust between Tehran and Washington causing a quick snap-back to previous sanctions, a risk that would probably much increase with a Republican President in the White House after next US election in 2016.
- Lower oil prices dashing hopes of windfall revenues for Iran of increased oil exports. Last November the IMF estimated that $10/barrel down on the oil price would weaken the current account balance by 1,75% of GDP and the budget by 1%/GDP. With the oil price now down to $25/barrel, the first would end up with a deficit of almost 4%/GDP and the budget deficit would increase to more than 6%/GDP. The overall situation of the country would then look much less attractive.
- Internal opposition could escalate against the end to sanctions. Vested interests are an important centrepiece of the political infighting. Already during the Iranian revolution in the late 1970 the Revolutionary Guard laid hands on important economic assets, most of them left over from the previous Shah regime. Recent years' sanctions have further benefitted their business and they are now reportedly fearful sanction relief may put an end to their new-won advantages.
- Potential military confrontation with regional neighbours incl. Saudi Arabia.

Iran

Key ratios	2016
Population (mil.)	80
GDP/capita (US$)	5 096
GDP (change)	4.2%
Inflation	9.3%
Curr.Acc. Balance/GDP	1.7%
Reserves/imports (months)	12
Budget balance (% of GDP)	-2.7%
Government gross debt (% of GDP)	15%

Chart Key:
Moving out from the centre implies less risk.



External ratings:
Fitch: Not rated
Moody's: Not rated
S&P: Not rated

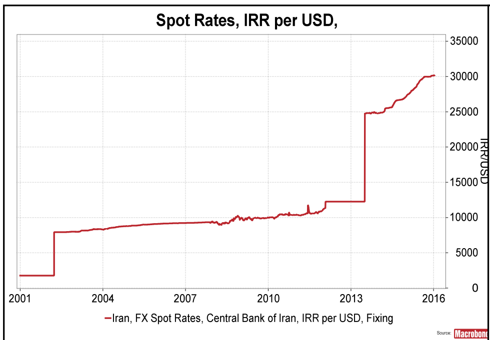
Peers:
Aregntina
Greece

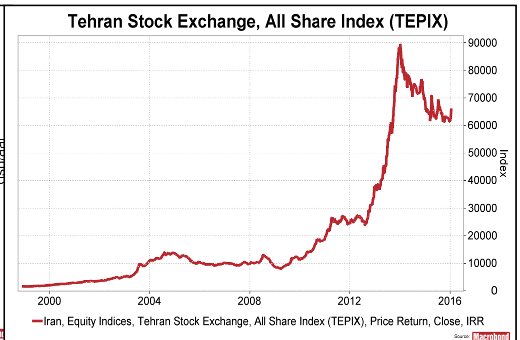
Graph: Iran scores very weak on most indicators except "macro balance" where it scores marginaly better than the average emerging market country.

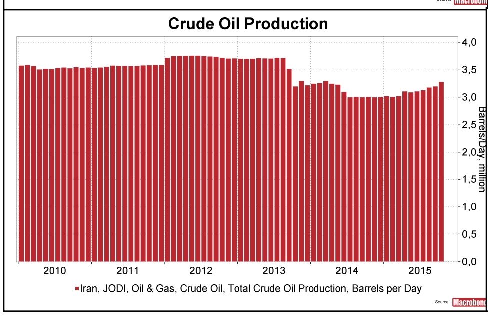
Key data:	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (US$ bil)	592	587	512	425	409	407	414	428
GDP/capita (US$)	7 870	7 707	6 630	5 443	5 165	5 096	5 122	5 242
GDP (change)	3.7%	-6.6%	-1.9%	4.3%	2.2%	4.2%	4.7%	4.6%
Investments/GDP	32%	26%	25%	25%	25%	25%	25%	25%
Budget balance/GDP			-0.9%	-1.2%	-3.9%	-2.7%	-0.6%	-1.7%
Govt debt/GDP (net)			15%	16%	16%	15%	14%	14%
CPI inflation (%)	20.6%	27.4%	39.3%	17.2%	13.8%	9.3%	9.0%	8.5%
Money demand (%)		33%	5%	14%	14%	13%	13%	13%
Stock prices (average)	161	179	360	493	522	553	571	654
Interest rates	11.2%	14.8%	14.8%	16.9%	11.8%	11.8%	11.8%	11.8%
Exch. Rate ($)	10616	12176	18414	25942	29020	31342	33222	35215
Trade/GDP (%)	38%	28%	30%	36%	33%	38%	43%	46%
Oil price (Brent)	$111	$112	$109	$99	$53	$47	$53	$58
Millions US $								
Export of goods	146	97	93	86	72	84	97	105
Imports of goods	78	69	61	65	64	71	82	90
Other:	-9	-5	-6	-6	-4	-5	-7	-8
Current account	**59**	**23**	**26**	**16**	**3**	**7**	**8**	**6**
(% of GDP)	9.9%	4.0%	5.2%	3.7%	0.8%	1.7%	1.9%	1.5%
FDI	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Loan repayments	-12	-2	-3	-5	-7	-9	-11	-11
Net other capital flows	-43	-21	-26	-14	1	-1	1	4
Balance of payments	**4**	**0**	**-3**	**-3**	**-3**	**-3**	**-2**	**-1**
Reserves	83	82	79	76	73	71	69	68
Total debt	15	7	8	7	8	9	11	11
o/w short term debt	8	1	2	3	6	7	8	9

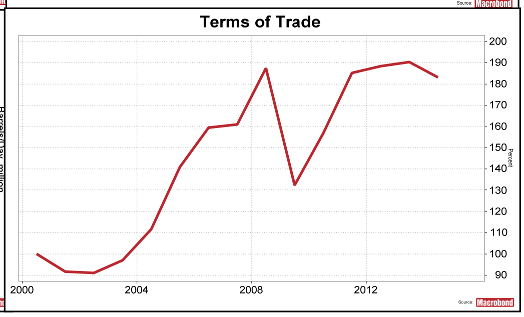
Sources: Oxford Economics and SEB estimates

Rating history	
Fitch (eoy)	Not rated
S&P (eoy)	Not rated
Moody's	Not rated
Type of government:	Theocratic republic
Next elections	2017 (Presidential), 2016 (legislative)
Other:	
Latest PC deal	
Latest IMF arrangements	









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