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Iran: Sharp turn ahead, drive carefully

After five years of sanctions, Iran is finally to rejoin the global community. The return of Iran should have an effect on international growth via the oil channel but, above all, will bring huge changes to Iran itself. The lifting of sanctions, following the P5+1 agreement, will have a significant effect on raising Iran's output. This will revive the Iranian economy, particularly through the recovery of foreign trade and investments.

However, moving from autarky to openness is a sharp manoeuvre to manage. The country may face a number of repercussions from trade liberalisation.

Greater macroeconomic perspectives, new opportunities

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, Coface expects real GDP growth to stand at 3.8% this year, on the back of the lifting of Western sanctions. With the removal of these sanctions, the Iranian governmental 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 foreign direct investments that Iran attracted in 2014.

"Key sectors that should lead the economy's recovery in the post-sanctions period include transportation, housing and urban development. Besides these industries and the oil and gas sector that the economy relies heavily upon, the country has opportunities in almost every sector", commented Seltem Iyigun, economist for the MENA and Turkey Region at Coface.

But the gains may be limited...

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. Weaknesses in the banking sector will also limit export growth.

"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", said Sofia Tozy, economist specialist on the Middle East at Coface. Furthermore, the sudden shock of trade openness may have an adverse effect on the country's exchange rate. An appreciation of the real exchange rate would be detrimental to local businesses.

The unfavourable global environment and Iran's structural problems may also delay the expected gains. Firstly, sluggish world trade and regional turmoil are likely to dampen the initial positive impacts from the lifting of sanctions and the reduction in trade costs. Secondly, as the

Iranian economy is heavily reliant on oil outcomes to boost its domestic economy, the fall in revenues induced by low oil prices could constrain public investment and the government's policy support for post-sanction growth. Finally, Iran's weak infrastructure and fragile banking sector will continue to hamper long-term growth prospects.

As regards industries, Coface has highlighted two sectors as being good illustrations of both the untapped economic opportunities and the challenges faced by Iran on entering the market.

- **Energy sector:** 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"*, said Sofia Tozy. Nevertheless, the upgrading of infrastructure will be costly. Moreover, 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.
- **Automotive sector:** The automotive industry, which accounts for more than 10% of Iran's GDP, will be one of the biggest beneficiaries from 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. However, this influx of foreign car manufacturers will create tough competition. *"The arrival of new 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,"* said Seltem Iyigun.

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