Euler Hermes Economic Research

Country Risk Analysis

# Iran

## Weak international relations (including sanctions) constrain economic and market potential

### General Information

| | |
|---|---|
| **GDP** | USD514.06bn (World ranking 22, World Bank 2012) |
| **Population** | 76.42 million (World ranking 17, World Bank 2012) |
| **Form of state** | Theocratic Republic |
| **Head of government** | Mahmud AHMADI-NEJAD |
| **Head of State** | Supreme Leader Ayatollah Ali Khamenei |
| **Next elections** | 2016, legislative |

### Strengths

- World's largest known natural gas reserves and the fourth largest oil reserves.
- Oil and gas reserves will last over 100 years at current rates of extraction.
- Large domestic market.
- Current account surpluses.
- Large FX reserves and good import cover.
- Low external debt obligations.

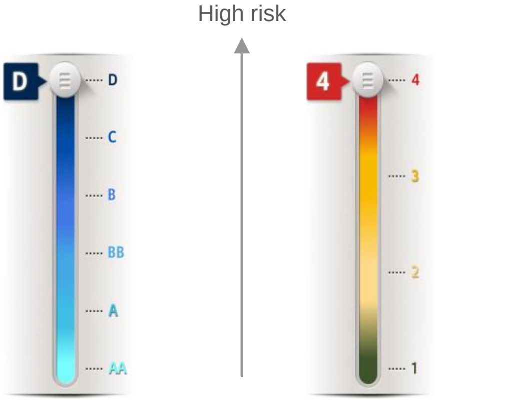
### Weaknesses

- Occasional conflict between the twin pillars of power – the government and the theocracy. Other power bases include the Revolutionary Guards.
- Tehran's desire for Iran to be a regional and international power led to a build-up of a nuclear capability outside IAEA safeguards and this has resulted in intense disagreements with the UN and the US, in particular, and international sanctions.
- Regional dynamics are negative: neighbours include Iraq to the west, Afghanistan and Pakistan to the east and the new Asian republics to the north. Moreover, Israel is perceived as a security threat.

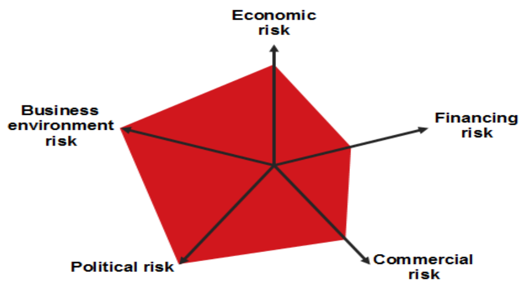
### Country Rating

D4

**Country Grade** **Country Risk Level**




### Risk Dimensions

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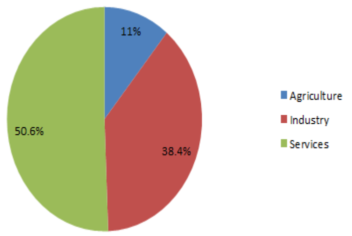
## Economic Structure

### GDP breakdown (% of total, 2011)




Sources: Chelem, UnctadStat, CIA World Factbook, IHS Global Insight, Euler Hermes

### Trade structure (% of total, 2011)

By destination/origin

| Exports | | Rank | | Imports |
|---|---|---|---|---|
| China | 21% | 1 | 29% | United Arab Emirates |
| Japan | 11% | 2 | 17% | China |
| China, Taiw an Province of | 10% | 3 | 7% | Korea, Republic of |
| Turkey | 9% | 4 | 5% | Germany |
| India | 9% | 5 | 4% | Turkey |

By product

| Exports | | Rank | | Imports |
|---|---|---|---|---|
| Petroleum, petroleum products and related | 81% | 1 | 14% | Iron and steel |
| Organic chemicals | 3% | 2 | 7% | Road vehicles |
| Gas, natural and manufactured | 3% | 3 | 6% | Other industrial machinery and parts |
| Metalliferous ores and metal scrap | 2% | 4 | 5% | Petroleum, petroleum products and related |
| Plastics in primary forms | 2% | 5 | 5% | Specialised machinery |

## Economic Forecast

| | 2009 | 2010 | 2011 | 2012 | 2013f | 2014f |
|---|---|---|---|---|---|---|
| GDP grow th (% change) | 4.0 | 5.9 | 2.1 | -3.4 | -3.0 | 1.5 |
| Inflation (%, end-year) | 7.3 | 12.9 | 22.1 | 36.2 | 35.4 | 23.4 |
| | | | | | | |
| Fiscal balance (% of GDP) | -4.7 | -1.8 | -1.7 | -3.8 | -3.7 | -3.4 |
| Public debt (% of GDP) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| | | | | | | |
| Current account (% of GDP) | 2.6 | 6.5 | 11.8 | 5.8 | 5.0 | 3.0 |
| External debt (% of GDP) | 5.0 | 4.7 | 3.8 | 4.9 | 6.9 | 6.5 |

Sources: IHS Global Insight, National sources, Euler Hermes

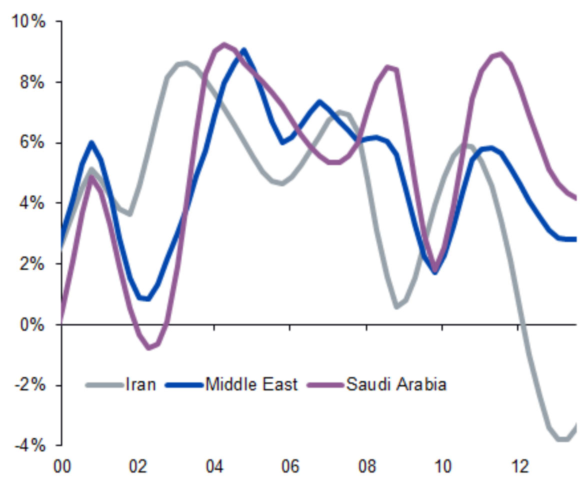
## Economic Growth

### GDP growth is dependent on international oil markets and on sanctions

GDP growth tends to be volatile (see chart), largely reflecting demand and price movements in international oil markets. However, since 2011, the GDP trajectory has become disengaged from that of other leading oil suppliers and from the region as a whole (see chart). This is partly because domestic political factors and international diplomacy also weigh on the Iranian economy. GDP is estimated to have contracted by -3.4% in real terms in 2012, reflecting the impact of sanctions, which curtailed oil exports and (through restrictions imposed on the finance sector) limited other commercial transactions. Policy mismanagement in the President Ahmadi-Nejad era further added to the weak economic environment in 2011-12. Indeed, with President Rohani only taking office in August 2013, these policies continued to weigh against expansion this year and EH expects GDP to contract by a further -3% in 2013.

The outlook for growth in 2014 is for moderate expansion. EH expects GDP to increase by around +1.5% in real terms but there are considerable upside and downside risks to this outlook. Much will depend on the course of oil prices. EH's central scenario is for oil prices to weaken, but not collapse, reflecting weak demand in some areas and further production of energy supplies from North American shale reserves. However, Iran's GDP growth could rebound more strongly if there is further easing in sanctions but could be even weaker if domestic reforms are not implemented and/or global sanctions are tightened.

### GDP growth (y/y, 4 qtrs cumulated %)




Sources: IHS Global Insight, Euler Hermes

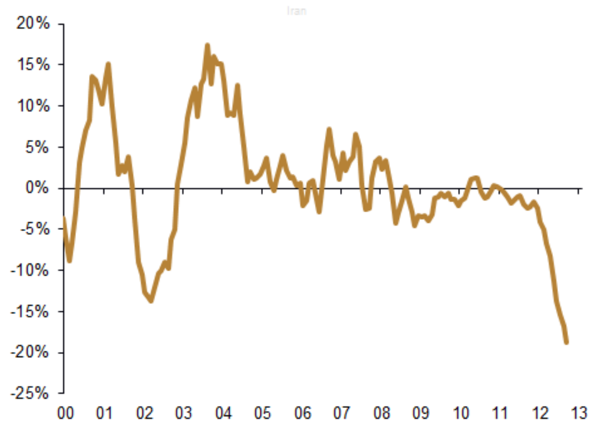
# Economic Policies

## Former policies (with a lingering legacy) limit economic development

Iran is now classified as a lower-middle income economy (until recently, upper-middle) reflecting declining nominal per capita incomes as a result of policy mismanagement and of imposition of international sanctions. The economy is dependent on oil and gas for around 20% of GDP, 60% of government revenues and over 80% of export receipts.

Overall economic strategy is laid down in five-year development plans but there were perceptions that the previous regime overlaid such planning with short-term policies with a distinct political agenda. The Ahmadi-Nejad government increasingly turned away from foreign investment and attempted to make the economy more self-reliant. However, this inward direction and constrained ability to source capital goods or raw materials from abroad caused a miss-allocation of resources and limited overall growth. It remains to be seen if the new government under President Hassan Rohani can implement an effective reform agenda and rebalance the economy. Initial signs are encouraging but significant challenges remain evident.

**Industrial production (%)**



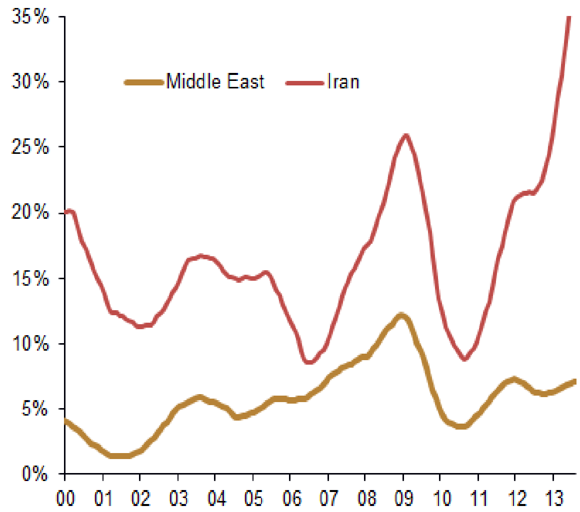

Sources: IHS Global Insight, Euler Hermes

## Significant inflationary pressures, reflecting fiscal largesse and IRR depreciation

Inflationary pressures tend to be above the regional average (see chart) and consumer prices have increased by double-digit growth rates in most years since 2000. Inflation at end-2012 was over 36% and averaged over 25% through the course of the year. Fiscal largesse and other unrestrained populist policy measures have added to inflationary pressures. In addition, domestic policies and international actions (sanctions) have weakened the currency, with significant IRR depreciation boosting prices of imported goods. EH expects consumer price inflation to be 35% at end-2013 but then for there to be some improvement through the course of 2014, although it will still register over 23% by the end of next year.

The economic authorities will continue to defend the IRR by using the country's large FX reserves (see chart on next page), which were accumulated through the pre-crisis oil-price boom. EH expects the rial to continue to depreciate into the medium term, with IRR28,600:USD1 at end-2013 and IRR34,175:USD1 at end-2014, compared with IRR10,353:USD1 at end-2010 .

**Inflation rate (%)**




Sources: IHS Global Insight, Euler Hermes

## Fiscal deficits

Despite sanctions, Iran earns considerable revenues from its energy exports and oil and gas generate around 60% of total government financial receipts. Even so, the central government fiscal balance registers regular deficits. In the period 2009-12, the average annual fiscal deficit was equivalent to -3% of GDP. EH expects the new government will begin to address the fiscal deficit but it will be constrained in this by concerns of the theocracy that too rapid policy tightening could undermine social cohesion and, possibly, adversely affect the vested business interests of some power bases. Accordingly, EH expects a fiscal deficit of -3.7% of GDP in 2013 and -3.4% in 2014.

## External Sector

### External accounts are strong but earning capacity is below potential

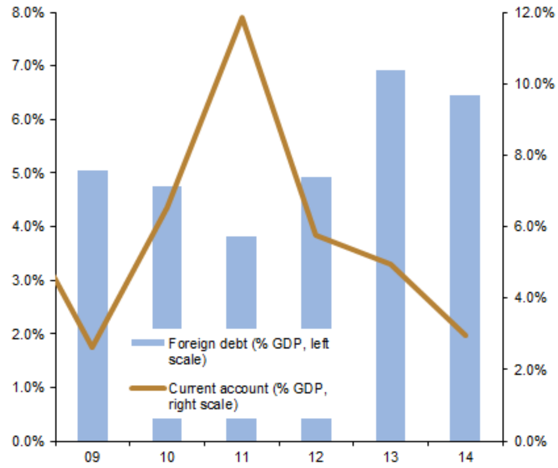
The strength of the external accounts continues to depend on internationally-determined oil prices and the country's associated revenue generating capacity. Crude oil and gas and related products account for over 80% of Iran's total export receipts. Strong current account surpluses were recorded in 2011-12, when oil prices were high (indicative average benchmark prices of USD111/barrel and USD112/b in 2011 and 2012, respectively, after USD80/b in 2010). The recent peak for current account surpluses was +11.8% of GDP in 2011 and EH expects current account surpluses to continue but at lower levels, with almost +5% of GDP in 2013 and almost +3% in 2014. Global oil prices are forecast to weaken in 2013-14, although they currently remain above USD100/b. At the most recent OPEC meeting, Iran pledged to increase oil output whatever the prevailing price and this could lead to sharp disagreements with Saudi Arabia.

Hard currency foreign exchange reserves are currently around USD70 billion, down from over USD80 billion at end-2012, partly reflecting their use to stem a too rapid depreciation of the IRR. At current levels, FX reserves provide an import cover of around 10 months, compared with an internationally-accepted comfort level of three months. EH expects FX reserves and import cover to be further depleted in 2014 but overall external liquidity will not be at risk.

### External debt levels and servicing of obligations are comfortable

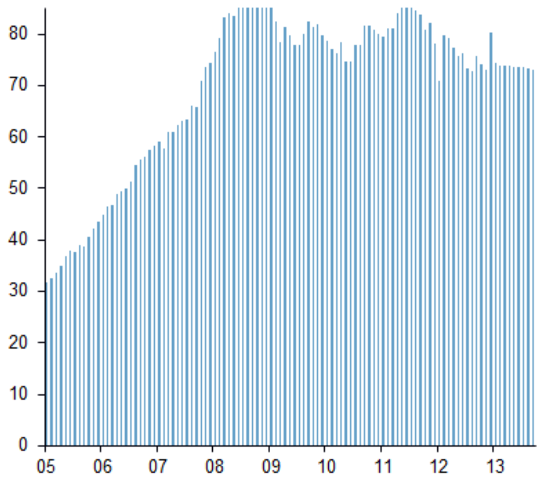
Partly as a result of Iran's partial ostracism from full involvement in international diplomatic and economic relations, external debt ratios are relatively low, with total foreign debt stock at <7% of GDP and around 20% of total export earnings and the debt service ratio on existing obligations is under 3% of total export receipts. As a result, external payments of debt obligations (and, by association, settlement of trade payments, where these do not contravene sanctions) will not be problematic.

**Current account and external debt (% of GDP)**




Sources: IHS Global Insight, Euler Hermes

**FX reserves (USDbn)**




Sources: IHS Global Insight, Euler Hermes



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