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An Analysis of Iran's Economic Developments

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Contents

- Briefly review some socio-economic indicators;
- Discuss key economic developments and indicators;
- Outline main objectives in Iran's 20-year Perspective;
- Identify shortcomings and bottlenecks;
- Discuss the outlook for future economic developments;

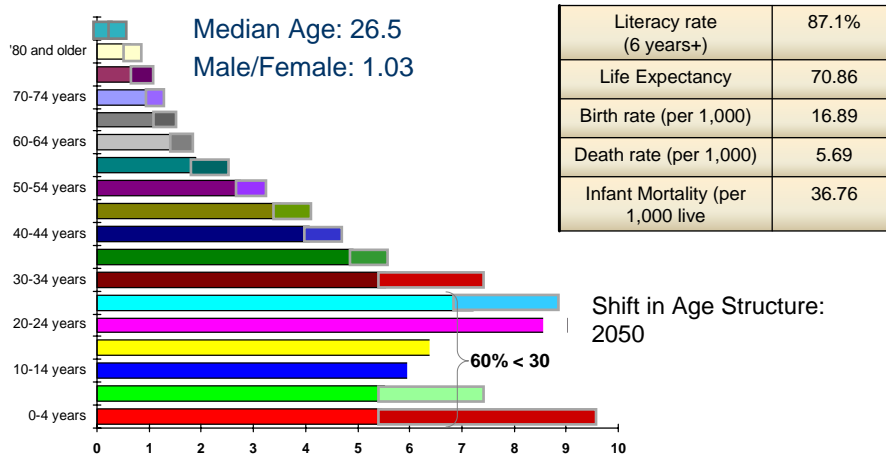
Snapshot of the Economy

Indicators	1386 (2007/08)	1387 (2008/09)	1388* (2009/10)
GDP growth	4.6%	4.0%	3.5%
GDP – in billion US\$ (GDP per capita in US\$)	\$280.2b (\$3,647)	\$350.0b (\$4,730)	\$440.0b (\$5,980)
Inflation Official (Unofficial)	19.1% (21.4%)	22% (30.0%)	20% (27.0%)
Liquidity growth	42.3%	40.0%	30.0%
Population (million)	71.5	72.5	73.6
Active work force	42.6%	44%	46%
Unemployment Official (Unofficial)	11.2% (14.5%)	12.5% (15.0%)	12.0% (15.0%)
Oil & gas exports	\$78.8bn	\$77.0bn	\$55.0bn
Non-oil export (incl. services)	\$18.0bn	\$22.0bn	\$25.0bn
Imports	\$55.7bn	\$57.0bn	\$60.0bn
Trade balance (incl. crude)	\$30.9bn	\$39.0bn	\$20.0bn
Budget deficit	\$13.5bn**	\$45.0bn**	\$30.0bn**
Foreign Reserves (hard currency and gold)	\$100bn	\$86bn	\$70bn
Exchange rate (IRR/US\$)	\$1=IRR9,420	\$1=IRR10,000	\$1=IRR10,700

Main source: Population and employment statistics are based on the report of Statistical Center of Iran (SCI). OSF Balance, GDP Growth, Inflation and unemployment rate and exchange rate figures are based on the CBI latest reports. The rest of the figures are prepared by Iran Economics Magazine (Eghtesad-e Iran), April 2009.

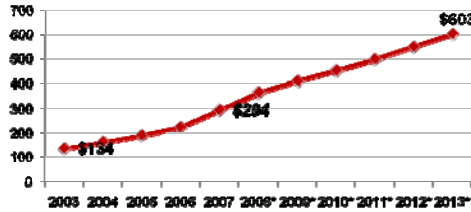
* Projected until the end of the current Iranian year 1388 (21 March 2009-20 March 2010)

Demography and Socio-economic trends

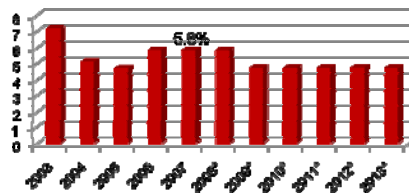


Economic Growth

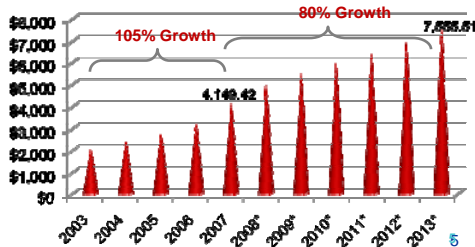
GDP (REAL) (billion \$US)



GDP Growth



GDP per capita(\$)



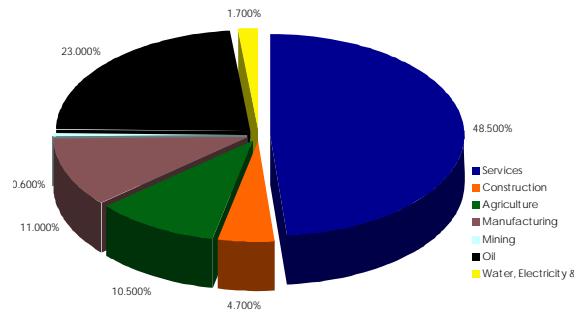
Important Note:

Based on the UN's PPP calculation of the GDP, Iran's GDP stands at \$750 billion, ranking 18th in the world.

Source: IMF, CBI, Iran Economist
* Estimated

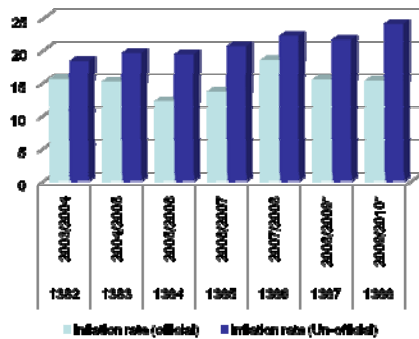
Composition of GDP

- Areas of Stated Government Emphasis over Next 5-Years
 - Mining
 - Energy-intensive industries
 - Automotives
 - Power generation
 - Banking and insurance
 - Roads and railways
 - Aviation and shipping
 - Telecom

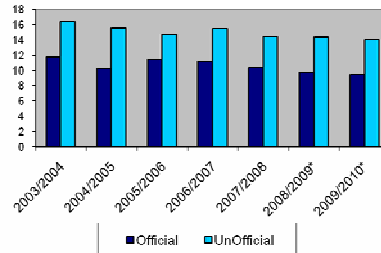


Unemployment - Inflation

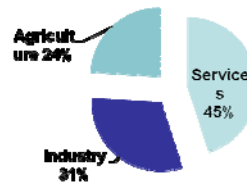
Inflation



Unemployment Rate



Labor Force Breakdown



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Plan versus Reality

Item	Actual Average Annual Performance 21 Mar. 2000 – 20 Mar. 2005 (3 rd Plan)	Target in the 4 th Plan (21 Mar. 2005 to 20 Mar. 2010)	Actual Average Annual Performance 21 Mar. 2005 – 20 Mar. 2009 (4 years in the Plan)
GDP Growth	5.5%	8.0%	6.3%
Growth in Capital Formation	9.5%	12.2%	4.8%
Liquidity Growth	28.9%	20.0%	33.8%
Inflation	14.1%	9.9%	15.6%
Non-oil export growth	16.2%	10.7%	26.6%

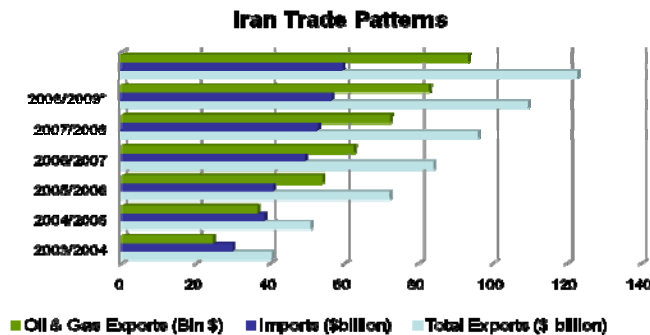
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Qualitative Comments

- Growing per capita income as well as fast-pace urbanization has led to consumption growth in modern products such as FMCG – this growth has helped the growth of private sector companies in Iran;
- The private sector has benefited from access to regional markets, especially Iraq and Central Asia;
- The upside in Iranian business over the next decade will be to secure a share in the difference between the PPP GDP (\$750 billion) and the nominal GDP (\$350 billion);
- Inflation and unemployment remain interrelated problems, but they won't go away in the next decade, especially due to demographic pressures;
- Youth unemployment currently stands at 27% and this is a major socio-economic challenge to the country!
- The main source of entrepreneurship for new jobs will be private sector activity;

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Trade Patterns



2007 Total Exports: \$97.4 billion

- Dominated by oil exports (83.9%)
- Petrochemicals, carpets and nuts

2007 Total Imports: \$56.6 billion

- Capital and Consumer Goods (70%)

2008 Total Exports: \$93.3 billion

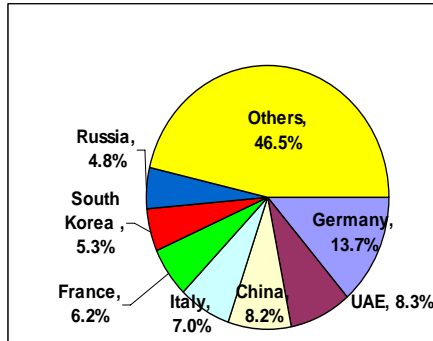
- Dominated by oil exports (82%)
- Petrochemicals, carpets and nuts

2008 Total Imports: \$58.7 billion

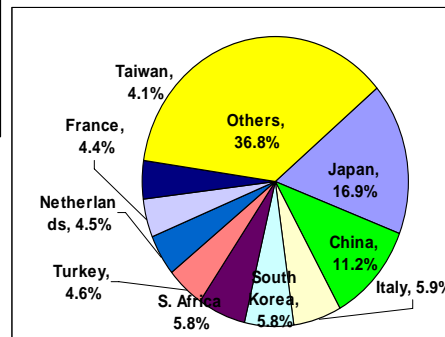
- Capital and Consumer Goods (70%)

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Trade Patterns



Major Imports from:



Major exports to:

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Key Current Plans and Policies

- Replace energy subsidies with targeted social assistance (cash hand-outs);
- Inject \$13 billion to recapitalize the banking sector;
- Divest 80% of the government's shares in state-owned enterprises in most economic sectors by 2010 (privatization scheme – discussed later);
- Introduction of 100%-owned foreign bank branches in Iran;
- Increase revenue from taxes, especially through the introduction of VAT on all products and services;

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Responses to the low oil price

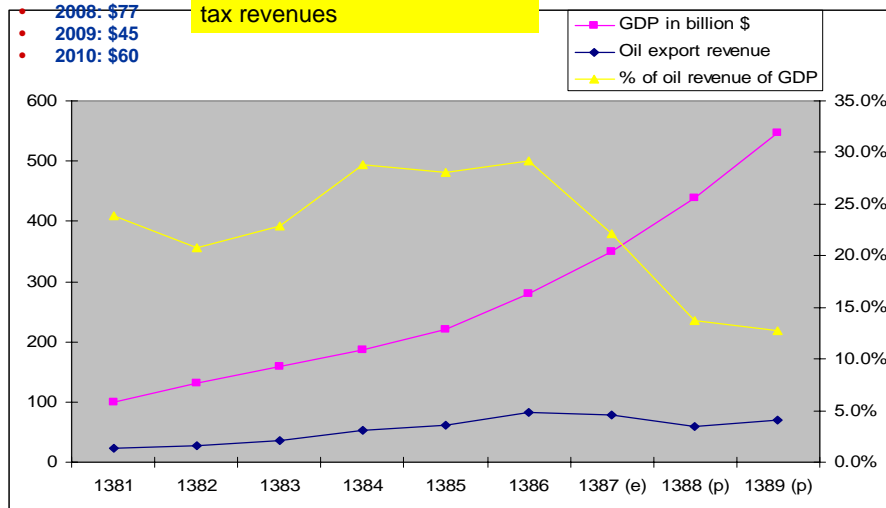
- **Populist policies of the past few years have raised expectations in Iran so that the government will need to compensate for the falling oil revenues;**
- **Furthermore, low oil prices have made Iran more vulnerable to a new round of UN or US sanctions;**
- **Key responses:**
 - Liberalization of the investment regime (this has already been started with a new law allowing 100% foreign ownership of companies in Iran);
 - More attractive contractual frameworks for foreign investors;
 - Push for faster privatization;
 - Banning of some of the luxury imports (including cars?);
 - Expansion of the country's tourism sector;
 - Issuance of new Eurobonds which will require financial liberalization policies;
 - Attempts to ease external tensions so that existing sanctions are eased (nuclear negotiations?)

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GDP and Oil Export Revenues

- Assumptions:
- Average crude price in:
 - 2008: \$77
 - 2009: \$45
 - 2010: \$60

Significance: The government will depend more and more on tax revenues

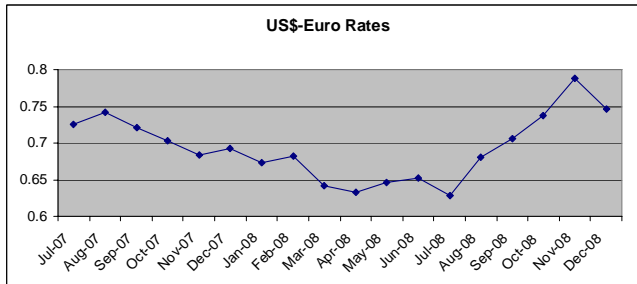
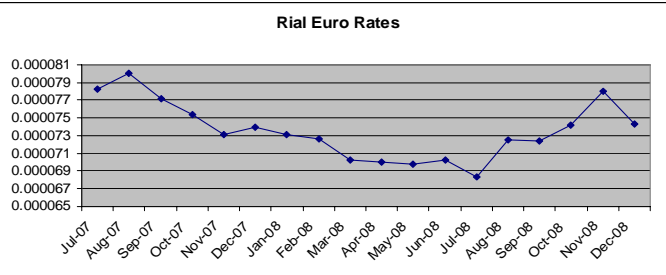


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Exchange Rate Trends

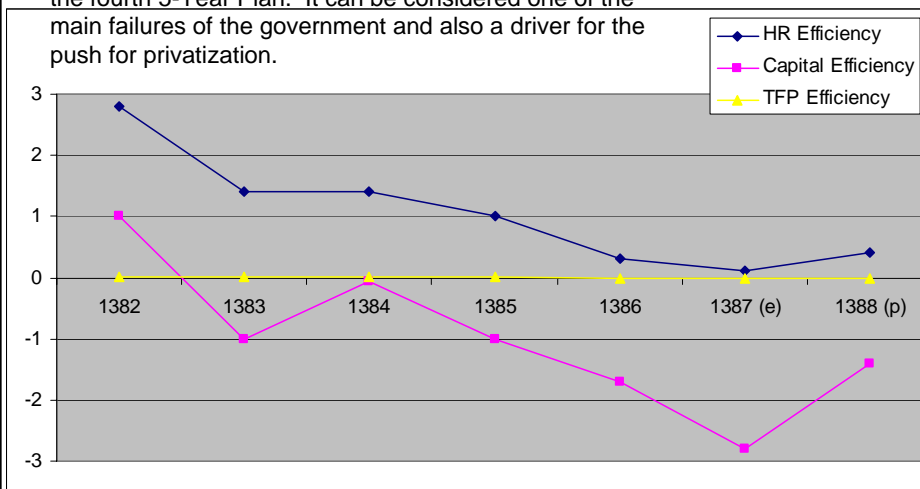
Since January 2008, the Iranian Rial is pegged against a basket of currencies that includes Euro, US\$, Yen and Swiss Francs. As such, the Rial is moving more independently of the US\$.

Our prediction for next year is that the Rial will devalue by about 5-7% against the US\$.



TFP Efficiency Rates

Efficiency Growth has been one of the main objectives in the fourth 5-Year Plan. It can be considered one of the main failures of the government and also a driver for the push for privatization.



Other Significant Trends

- The economy will continue to be behind in terms of job creation – populist government schemes will produce short-term occupations through loans, but sustainable jobs will fall short of the actual needs in the society;
- The private sector is the main provider of jobs (81% of jobs are rooted in private sector activity), but the government's dominance (72% of economic activity) is undermining efficiency;
- Gross Capital Formation in Iran has been around 15 to 20% of the GDP over the past few years, but what is required for a solid economic development is about 25%;
- Private sector activity is on the rise, not because of a successful privatization, but mainly due to the growth of new private sector initiative – it is now estimated that some 28% of the economic performance is derived from real private sector activity;

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A Look at Privatization

- Despite the apparent political will from the government, the privatization process will continue to suffer from political and legal challenges;
- The existence of a growing number of semi-governmental institutions (the list is now joined by IRGC-affiliated companies, regional cooperatives etc.) undermines the position of the true private sector;
- Some private sector players are pushing to book certain sectors "exclusively for private sector", but it is impossible to achieve;
- The most realistic prospect will be that a majority of the government companies will be sold to the semi-governmental institutions and that the private sector will mainly end up with marginal entities, if any at all;
- Not all government entities will be successfully sold and some of them may be dissolved or merged over time;
- From the companies that will be sold to the intermediary organizations, some will not survive and others may be transformed through JVs and cooperation with private sector;
- The central issue in Iran's economy is not ownership, but rather management styles and attitudes and one needs to assess the developments on that front;

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20-Year Perspective

- With all these conflicting power centers in Iran, we need to identify “the common vision” which is provided in the “20-Year Perspective” Document.
- Essentially, Iran strives to be the regional technological and economic powerhouse by 2025;
- It envisages a Knowledge-based society in Iran. Therefore, all issues relating to the generation or transfer of knowledge to Iran as well as to job creation will be welcomed by all the above mindsets.
- In foreign policy, the document envisages extensive interaction with the rest of the world and seeks an active international profile for Iran;
- In the energy sector, the plan envisages developing Iranian resources, with a special attention to gas as the underdeveloped resource in Iran and on shared oil resources;
- Core overall objectives are:
 - Technological progress;
 - Economic development;
 - Regional consolidation through commercial and cultural relations;

Iran’s balance sheet to achieve economic growth

- | | |
|--|---|
| <ul style="list-style-type: none"> • Available factors: <ul style="list-style-type: none"> – Human resources; – Young dynamic society; – Existence of a vibrant private sector culture; – Internationally oriented scientific and academic pool; – Material wealth; – Desire and capacity to achieve sustainable economic growth; – Desire to connect to global economic developments; – Diversity of economic sectors; | <ul style="list-style-type: none"> • Needed elements: <ul style="list-style-type: none"> – Economic Doctrine; – Higher Efficiency; – More balanced economic structure; – Government policies on promoting innovation and entrepreneurship; – Growth of the private economy; |
|--|---|

Presidential Candidates and the Economy

Candidate	Comments
Ahmadinejad	<ul style="list-style-type: none"> • Populist policies favoring poorer income classes • Provincial development; • Project awards to domestic companies
Moussavi	<ul style="list-style-type: none"> • Social justice through structural adjustments and investments; • Protectionist policies;
Karrubi	<ul style="list-style-type: none"> • Trade-oriented; • More focused on traditional capabilities of Iran; • Pro-foreign investment;
Rezai	<ul style="list-style-type: none"> • Tendency towards technological progress as the main driver of economic development; • Increased interaction with the rest of the world;

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Presidential Scenario 1: Ahmadinejad is re-elected

- A re-elected Ahmadinejad will feel boosted in his views and he will push forward his populist agenda;
- Nonetheless, he cannot impose his views on the entirety of the regime with regards to nuclear negotiations and potential Iran-US ties;
- It is conceivable that a second Ahmadinejad term would be more moderate than the first term, but the process of Iran-US rapprochement would become more challenging;
- The main short-coming in this scenario will be Ahmadinejad's insistence in using young, inexperienced forces in government;
- Iran-Israel tensions will remain high, but the overall regional standing of Iran will depend on many other regional aspects, especially the situation in Pakistan and Afghanistan;
- The economy will continue to suffer from populist policies, but it is conceivable that the Expediency Council will interfere more forcefully in economic decisions;
- The regime would push for a resolution of the nuclear stand-off, but there will be a weakness of the diplomatic apparatus in finding creative solutions.

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Presidential Scenario 2: Ahmadinejad loses in the 2nd round

- It is likely that the non-Ahmadinejad forces will build a Coalition for the second round – no matter who goes into the second round, most forces will put their weight behind him - Therefore, this scenario will entail the utilization of diverse factional views and figures in the government;
- This will pave the way for the return of many reformist figures to the executive power;
- The fact that Ahmadinejad would be out of office, would facilitate an American overture to Tehran - the Iran-US agenda would mainly be dominated by Ayatollah Khamenei, but the coalition government would facilitate the process;
- The nuclear negotiations may become complicated due to the diversity of views in the government, but a solution would be feasible;
- Economic issues would be left to a team of Strategic and/or Technocratic Mindsets who would seek more professional approaches in addressing the current challenges;

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Conclusions / Outlook

- The Iranian economy will continue to produce mixed signals and mixed indicators;
- The planned lifting of subsidies will be a painful, but necessary process – in the short-term increasing inflationary pressures;
- The middle class will be the main losers of the economic adjustments of the next two years, however, some of their pressures will be corrected through higher than average salary increases;
- A change of government will not only lead to policy shifts, but also will introduce more experienced technocrats into key positions;
- The gradual shift of the economic composition in Iran will not emerge as a result of privatization, but mainly as a result of the growth of new private sector initiative and a decline of government activity;
- Lack of TFP efficiency will remain the central challenge and it can only be addressed through significant growth in private sector and foreign investment;
- Low oil prices will ultimately have a positive impact on the Iranian economy as the government will become more dependent on tax revenues as well as private sector and foreign investment;

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