Will Iran Become A Successful Emerging Market?

By David Hale

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If the nuclear deal with Iran succeeds, the world will see a great shift in geo-politics and economic growth.

Iran has reached an agreement with the United States and five other countries to curtail its nuclear development program in return for economic sanctions being lifted. They plan to provide a final blueprint of the deal in June.

What are the potential economic consequences of a deal with Iran? It has the potential to be a transforming event not just for Iran, but also for the global economy.

The Iranian perspective

As for Iran, the country suffered from economic mismanagement before Hassan Rouhani became president. The nuclear deal could transform Iranian politics, allowing it to become more pro-business and pro-investment.

It will be difficult for the government to remain hostile to the West if foreign companies are creating jobs and increasing the supply of consumer goods – each of which is something the country desperately needs.

True, the Iranian Revolutionary Guards oppose a deal because they earn large sums from violating the sanctions. But that pits them against the Iranian people who want to escape from such corruption and end Iran's status as a pariah state.

As for the debate in the U.S. Congress, the Republicans – who also oppose the deal — have not yet heard from U.S. corporations, a traditional ally. Large firms could benefit from a re-engagement with Iran.

Sanctions have reduced U.S. exports to Iran by as much as $175 billion during the past 17 years, according to a study by the National Iranian American Council (NIAC). Both U.S. and European businesses will be excited about the prospects of tapping into this major frontier market, but the process will take time.

Effects on the global economy

The first effect on the world economy, once sanctions are lifted, will be that Iran will be able to increase oil exports. Iran could probably double oil exports in the year ahead. In 2009-11, Iran was producing 3.5 million barrels per day (bpd) and exporting 2 million bpd. The 2010 sanctions cut oil exports in half.

Once the sanctions are gone, many foreign oil companies would return to Iran and invest in developing new oil reserves as well as reviving older fields with modern equipment.

Iran's new exports would probably drive the oil price down to $40 per barrel next year. This could produce a positive shock for the oil-importing nations and a negative shock for oil exporters.
Every $10 decline in the oil price could transfer 0.5% of GDP from oil producers to oil importers. It would be a de facto trillion-dollar tax cut at a time when most industrial countries are focused on deficit reduction — and thus cannot cut taxes.

The major winners would include Japan, India and Europe because they import most of their oil. The U.S. economy would also benefit because it still imports about one third of its oil consumption.

Worries for Russia and Venezuela

The second major consequence of falling oil prices would be to further undermine the economies of Russia and Venezuela. Oil and gas account for 69% of Russian exports and 45% of the government's tax revenues.

The combination of the oil price decline and Western sanctions will probably cause Russian GDP to fall by 4-5% this year. New Iranian exports could set the stage for a further 3-4% contraction next year.

Russian policymakers had been budgeting for a $100 oil price this year which, absent some exogenous shock, will clearly not occur. The devaluation of the Russian ruble is helping to offset some of the revenue effects of the falling oil price, but it cannot offset a major decline in the value of country's exports.

In fact, the downturn of Russia's economy could create a peace dividend, by limiting Russia's ability to increase military spending (and pursue new conquests in the Ukraine).

Venezuela will be highly vulnerable to a further oil price decline. Oil accounts for over 90% of the country's exports. Meanwhile, the state oil company, PDVSA, provides over half of government revenues.

Venezuela is already confronting a fiscal deficit amounting to a staggering 17% of GDP, so the decrease in oil revenues could force its central bank to resort to hyperinflation to fund the government. The country's inflation rate is already over 60% — and still rising.

Venezuela had chronic financial problems when the price of oil was over $100 per barrel because of economic mismanagement. A new oil price decline will only intensify these problems and possibly force the government to default on its debt.

A large oil price decline might also force President Nicolás Maduro to curtail low-priced oil exports to Central America and the Caribbean. These exports cost Venezuela $2.3 billion per annum in what are effectively oil price subsidies for its neighbors.

Iran's reengagement with the global economy

Iran has 78 million people and the 27th largest GDP in the world, at about $437 billion. Iran's central bank estimates that this GDP is composed of 52% services, 18% oil, 13% manufacturing and mining, 12% agriculture and 5% construction.

Many Western companies are keen to invest in Iran in both the oil sector and manufacturing. Some major companies are still there — despite the sanctions. Danone, Coca Cola, Pepsi and Nestle are in the consumer sector, while MTN of South Africa has a major cellular phone operation. Nestle is keen to grow in a market that was the company's third-largest in the world before the 1979 revolution.

If Iran's economy rebounds after the sanctions are lifted, the country could have a GDP growth rate exceeding 6% by 2017.
If successfully concluded this June, the Iran deal could set the stage for a further revival of the global economy, as well as profound changes in geopolitics.

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