PolicyWatch 2433

Have International Sanctions Crippled Iran's Auto Industry?

Nahid Kalbasi

June 3, 2015

The major industry has been better prepared than expected, but it still suffers from lack of liquidity and sluggish growth due to banking restrictions and other inefficiencies.

Although Iran's economy has been suffering from the adverse effects of intensified international sanctions since 2007, different sectors have shown different levels of fragility. While the monetary sector has been hit hard, the real sector has been more resilient due to protectionism and new trade partners, which helped the country avoid the worst outcome. Since automobile manufacturing is Iran's second largest industry, it offers an important window into the actual effects of the ongoing sanctions. Has the industry effectively shielded itself from the compulsory isolation? And what role have macroeconomic fundamentals had on output levels and prices since the sanctions were implemented?

BACKGROUND

The auto industry accounts for 10% of Iran's GDP and 4% of its workforce, second only to the hydrocarbon industry. Indeed, Iran Khodro is the largest automobile manufacturer in the Middle East. Although Iran's automobile output has dropped from 17th to 20th in the world since 2008 -- the year sanctions were reinforced -- it still produces more cars than countries such as Italy, Austria, Australia, and the Netherlands.

Iranians had been expecting the sanctions for quite a while, so they were better prepared than others might have been. Iranian firms were able to work with companies in the Persian Gulf and Eastern Europe to overcome some of the resultant challenges.

OUTPUT TREND SINCE 2011

From 2011 to 2013, Iran's production of cars dropped substantially due to sanctions, from 1,420,000 to 624,750. (Although official figures for total vehicle production in 2011 are not available, 85% of the industry's output in 2013 consisted of cars, with SUVs accounting for another 14% and trucks/buses around 1%, so the car statistics alone are indicative of the major drop after 2011.) Meanwhile, imported cars totaled USD 3.7 billion in 2013, almost 12.6% of domestic production.

Yet this trend reversed in 2014, after nuclear negotiations moved into a new phase and sanctions were partially eased in late 2013. Production increased by 53%, from 736,948 total vehicles in 2013 to 1,130,164 in 2014. The industry also experienced 41% growth in the first month after the Iranian New Year (March 21-April 20) compared to the same period last year.

The sharp devaluation of Iranian currency -- by more than 200 percent since sanctions were reinforced -- has led to a sharp rise in the price of imported cars. As a result, many consumers have turned to domestic cars. To further support the industry, Iranian authorities are also considering an increase in tariffs, from the already steep rate of 40% to perhaps 70%. Yet domestic production has increased very little when tariffs have been raised; economic modeling in another study indicates that fundamentals such as banking loans and business cycles play a more important role in shaping domestic production. Therefore, access to international banking loans through removal of sanctions is a priority for the Iranian government and, more important, for the auto industry's survival. Lack of such access prevents the industry from achieving a sustainable economic growth path, at least in the short run.

ABOLITION OF SUBSIDIES AFFECTS CAR PRICES

The amount of foreign currency used to produce a car in Iran is around $2,500, whereas the average imported car costs around $8,000, creating a comparative advantage for domestic producers. With a production of 1.1 million vehicles in 2014, Iran has been able to save almost $6 billion. Moreover, the country's economic dependency on oil revenue has dropped during the past few years due to the abolition of subsidies on utilities, gas, and other essentials. Ironically, 25% of the rise in car prices can be attributed to economic fundamentals such as the increased price of electricity and removal of other subsidies.

Given its more agile responsiveness to outside conditions, the auto industry has grown five times faster than Iran's

average industry in 2014-2015, and more than four times faster than GDP. It has also contributed substantially to government revenues; almost 25% of its sale revenue is allocated to the government (via taxes) and government-affiliated organizations (via profits they receive). In addition, the industry has been able to invest $10 billion in 2014, or 20% of its value added.

Another way in which Tehran has shielded the industry from the outside storm is by expanding trade relations with Eastern Europe and China. The major Chinese auto manufacturer Chery, which began exporting cars to Iran in 2005, has become a major partner of Iran Khodro during the sanctions years. Meanwhile, more than twenty Chinese automakers and other manufacturers have entered Iran's market since 2007, including Lifan, Changan, Haima, Dongfang, Futun, Brilliance, and MG. Currently, Chinese brands account for only 6% of Iran's market share, but this figure is expected to increase substantially.

At the same time, Iran's lack of access to liquidity and international financing is a real obstacle to further auto industry growth. Each of the major producers needs loans of at least $500 million to expand and update their facilities.

CONCLUSION

Despite the various shocks that Iran's economy has experienced from international sanctions, the real sector -- particularly the auto industry -- has been more resilient due to protectionism and expanded trade relations with China, Eastern Europe, and some Gulf states. Yet lack of access to financial facilities remains the most severe challenge for Iranian automakers, so the government will need to turn back to the international community if it hopes to put the industry on a steady-state growth path. The lifting of sanctions would of course help in this regard. In addition, it could give the West a market share in a major regional economy with millions of young consumers, with the potential to change the future course of the Middle East.

Nahid Kalbasi, an adjunct faculty member with Northcentral University, formerly served as an economist at the Central Bank of Iran and the Ministry of Economic Affairs and Finance.