Tundra comment: Iran's nuclear deal and the implications on Pakistan

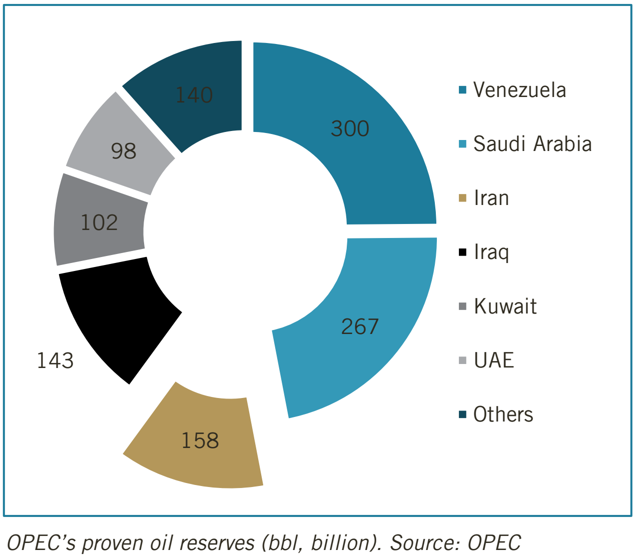
July 17, 2015

Landmark agreement

After 18 long days of intense discussions and deliberations, Iran and P5+1 member states* finally reached a landmark agreement, which is likely to lift the UN sanctions on Iran. This could provide a relief of billions of dollars in sanctions and a return pass to the global economy for Iran. In return, Iran has promised to halt its nuclear weapon development program. This deal will lead to moderation of conflict between the US and Iran, and will have positive economic implications for not only Iran, but also for some of Iran's trade partners and neighbors. As crude oil prices are likely to trend lower, Pakistan, which is a net importer of crude oil, might also be able to benefit from this deal.

The deal and the oil market

The most far reaching impact of this deal is likely on the international crude oil market. Iran is a member of the Organization of the Petroleum Exporting Countries (OPEC), and has the third largest proven oil reserves of 157.5bn barrels (bbl) amongst OPEC member nations, after Venezuela (399.9bn bbl) and Saudi Arabia (266.6bn bbl). Iran's share of the total global crude reserves amounts to 10.6%.



OPEC's proven oil reserves (bbl, billion). Source: OPEC

Fear of influx of Iranian oil into the world oil market is likely to keep the oil prices in check as Iran can pump up to an additional 0.15m bbl/day crude immediately. This can increase to 0.25m bbl/day next year. However, to make a considerable difference to the oil market dynamics, Iran will have to invest heavily in the oil exploration infrastructure. That said, WTI and Brent have already corrected by 14% and 10% respectively since the start of July.

Implications for Pakistan

As Pakistan imports up to 2/3 of its fuel requirements, lower international oil prices is good news as this could translate into a lower trade deficit for the country. However, due to affordability, we saw increased usage of oil products and hence oil imports in volumes increased by ~60% in 2H FY15, keeping the total import bill in USD terms flattish in FY15 compared to last year. Pakistan's Consumer Price Index (CPI), which closely tracks oil prices, fell to multi-year lows during FY15, and currently stands at 3.2%. If oil prices remain in the USD 50-55/bbl range, baring other economic shocks, Pakistan's inflation target for FY16 is likely to remain well within the annual target of 6%. The Iran Pakistan Gas Pipeline project initiated by the previous government, that had hit the snags due to the sanctions on Iran, is likely to be re-started. Iran and Pakistan plan to build a gas pipeline bringing in ~750mmcfd** gas into the energy-starved Pakistan, which could be very instrumental in reviving industrial growth.

Teheran, the capital of Iran.

** P5+1 refers to the UN Security Council's five permanent members (China, France, Russia, the UK, and the US) as well as Germany.*

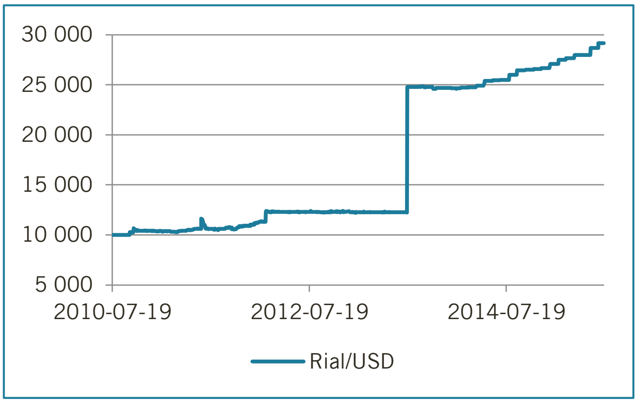
*** Million cubic feet per day.*

The Pakistani oil and gas sector

Impact of lower oil prices on Pakistan's oil and gas exploration sectors earnings will be limited, due to the applicable pricing policies. These have crude oil prices capped at as low as USD 30/bbl. Moreover, gas prices in Pakistan are already subsidized, hence, lower crude oil prices will not mean further reduction in gas tariffs. Gas tariffs in Pakistan, are in fact set to rise after the Eid holidays.

A mixed bag for the cement sector

Pakistan's cement sector has lately been facing competition from Iranian cement in Pakistan's largest export market Afghanistan. Iranian cement is seeping into Afghanistan through Pakistan, for less than USD 45/MT.



Source: Bloomberg

Some believe that appreciation of the Iranian Rial is likely to make the Iranian cement expensive and hence unviable, which could help the Pakistani cement sector. However, we believe, once the sanctions are lifted, Iran is likely to be able to export its cement to other regional markets too, which are currently being tapped by the neighboring Pakistan, thus increasing competition for Pakistan's cement players.

Positive for Pakistan and other frontier markets

Although the effect of the nuclear deal is limited for certain individual sectors, the deal is positive for Pakistan as a whole. The export bill for petroleum products will be reduced and the inflation kept under control. A more stable geopolitical environment will in the long term also contribute positively to the country's development.

Worthwhile keeping in mind is that Pakistan is not alone among the frontier markets being a net importer of oil. We pointed out in a research note dated October 2014 that countries such as Bangladesh, Sri Lanka and to some extent also Vietnam are net importers of oil. An apparent loser in the context is Nigeria, which with its 2.2m bbl/day is a substantial exporter.

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