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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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The collapse in confidence in the Rial

Since our last edition in which we highlighted the United Arab Emirates' (UAE) decision to terminate Noor Islamic Bank's relationship with Iran and tighten Dirham trade, the Iranian government has been unable to repatriate its oil revenues or foreign currency reserves back to Iran. The Central Bank of UAE had placed an exchange limit of 1.5 billion AED on the CBI per month – the CBI reached that limit in the first week in January and has to wait another month before they can complete any more AED transactions. Combined with the US decision to designate the Central Bank of Iran (CBI), and the European Union (EU) decision to introduce an embargo on Iranian oil, confidence in the Rial has collapsed.

In recent weeks, the unofficial exchange rate fell from IRR15,000:USD1 to IRR 23,000:USD1, exceeding our forecast of IRR20,000:USD1. It is now trading at IRR18,3000. Gold is trading at up to a 30% premium to the international price. The CBI has sought to put in place controls on foreign exchange dealers and prevent free trade in the unofficial market. Iranian authorities are cracking down on unauthorized foreign exchange dealers; however, this effort is failing to halt the collapse in the Rial and bazaaris are increasingly resorting to USD and gold for their transactions. The currency volatility has drastically curtailed trade in the bazaar with prices for some electrical and white goods doubling or trebling overnight. There is also evidence to show that the price of basic foodstuffs has begun to spiral.

The CBI is failing to supply adequate amounts of hard currency to authorized foreign exchange dealers, in particular USD, with the daily amount distributed falling to as low as USD 200,000. The banking sector in Iran is continuing to struggle to keep pace with demands from depositors to withdraw their Rial holdings in order to convert them into gold or other hard currencies.

There are signs that the currency crisis is spilling into neighbouring countries. The Deputy Governor of the Iraqi

Central Bank, Mazhar Muhammad Salih, recently spoke of his concern that daily demand for USD in Iraq has doubled from USD 160 million per day to USD 300 million per day. He attributed the increase in demand to the shortage of dollars in Iran and in Syria. He was concerned about the risks to Iraqi forex reserves which currently stand at USD 60 billion.

VERITY predicts that the run on the Rial will continue. As readers may recall, VERITY revealed in previous issues that a CBI internal report suggested that the Rial could be worth as little as IRR50,000:USD1. Given the total loss of confidence in the Rial, it is quite possible that in the short term, if the CBI fails to repatriate its forex reserves to support the Rial, the Rial could fall as low as IRR50,000:USD1 – or could even overshoot this rate. In previous VERITY newsletters, we recommended readers move their investments to USD, Norwegian Krone, platinum, or Gold Mining stocks; we still hold that these would be far more secure investments that the Iranian Rial.

What will the CBI do?

All eyes are on the CBI to see whether they can rescue the Rial from freefall. There are a number of options available to the Central Bank:

Repatriation of forex reserves to defend the Rial: The CBI has been unable to access Iran's foreign exchange reserves to repatriate them back to Iran. And even if they manage to do so, there is a risk that with confidence in the Rial so low, the CBI could exhaust its foreign currency reserves and still fail to prop up the Rial. The total Iranian deposit base is USD 300 billion, of which USD 70 billion is in on-demand accounts. If this money is withdrawn in full, Iran's USD 80 billion foreign exchange reserves could very quickly be completely wiped out.

Print money: There is some evidence (not least the current inflationary pressures) that suggests that the Iranian government is already printing money. A further USD 2,000 billion is being printed ahead of Nowruz. The CBI needs to print money to fund the subsidy payments, but also to bail out the banks (see our analysis of the state of the retail banks below). Needless to say, this will add to inflation and further damage confidence in the Rial.

Raise interest rates: TOO LITTLE, TOO LATE: In an effort to stabilize the market and control the continued devaluation of the Rial, the CBI recently raised interest rates from the existing 12% to 21%. This is unlikely to tempt Iranian investors – and the signs are that, despite this measure, the Iranian currency has failed to rebound. Following the 100% fall in the Rial, we forecast inflation will rise steeply from 40% to 70%, eradicating the 21% return offered by the banks. The loss of consumer confidence in Rial as well as in the Iranian banking sector makes it unlikely that deposits will be attracted back into the retail banks.

Likelihood of a collapse in the banking sector

With banks failing to make any money from letters of credit, their deposit base is haemorrhaging as customers withdraw Rials to convert them into USD and gold, and many of their customers are unable to repay their loans. If, as expected, confidence in the banking sector is eroded further, and the possibility of a total collapse in the banking sector increases, the CBI will have to print money to bail out the banks. This would markedly add to inflation. For the meantime, as the run on the retail banking sector continues, more businesses are failing to access loans or letters of credit. As a result, industrial production in Iran is collapsing with factories operating at below one fifth of capacity. This is likely to contribute to a sharp increase in unemployment and further problems with non-payment of wages. The collapse in industrial production will clearly have a knock on effect on the banking sector where we expect a sharp rise in delinquent loans. As readers may recall from previous issues, the Iranian government owes the CBI USD 25 billion up 50% from last year; and Iranian banks owe the CBI USD 34 billion up 80% since last year. It is likely that the CBI will find it hard to recover any of these loans. Banks Saderat, Melli, Mellat, and Tejarat are all in financial difficulties. The latest US designation of Tejarat will add to their problems.

Growing difficulties of Iranian banks in Dubai

Banks Saderat and Tejarat are effectively bankrupt. Bank Melli is also in a precarious financial position. A run on the Iranian banking sector is taking place as Iranians convert their Rial-denominated savings in retail banks into gold and foreign exchange. VERITY understands that Bank Melli in Dubai is facing growing difficulties as a result of overdue payments from Iranian banks and other customers on letters of credit and other financial instruments. Speculation is growing that Melli may even default on its payments and is now seeking urgent assistance from the CBI in order to mitigate the situation. Bank Saderat in Dubai is facing a daily USD 180 million funding shortfall.

Banks: shift from a strong sell to a liquidation recommendation

Inflation likely to climb steeply

As we have stated previously, we estimate inflation to be at 40%. With the collapse of the Rial, and signs that the CBI is printing money to shore up the banking sector and to pay subsidies, we expect inflation to climb to close to 70% by Nowruz. There have been calls within government for the implementation of price caps on certain goods. If the CBI starts printing money to bail out the banks, inflation could climb above 100% and hyperinflation would become a real possibility.

Dwindling Oil Exports and Increasing Banking Troubles

The EU has agreed to suspend the import of 450,000 barrels a day of Iranian crude oil and freeze certain assets of the CBI due to mounting concerns about Iran's nuclear ambitions. This measure, which will affect approximately 20% of Iran's crude exports, will come into effect after a 6 month period to enable the principle importers of Iranian crude in the EU, Italy, Spain, and Greece, to find alternative suppliers. The EU as a whole is negotiating with other oil-producing nations, such as Saudi Arabia and the UAE, to increase supply in order to mitigate the loss of Iranian oil. Iran will also find receiving payment for its remaining oil exports to be increasingly difficult because of global bank restrictions on transactions with China, India, Japan, and Korea.

Iran is already experiencing difficulty receiving payment for its oil exports because of EU and US sanctions against 29 of Iran's largest banks. The existing sanctions prohibit large global banks from acting as correspondent banks to the CBI. Iran's hard currency transfer costs are substantially increased as the CBI is forced to deal with smaller, non-global banks, like those in Ukraine or Azerbaijan. The situation for receipt of payments is likely to become more complicated as new US and EU sanctions will target the CBI.

Oil Companies: shift from a neutral position to a sell recommendation
Non-Oil Exporters: move from a buy to a hold recommendation

Statistics

GDP growth
-2% (2012 best case estimate)
vs. IMF estimate: 3.4%
vs. CBI estimate: 3.5% – 4.5% (1388)

Inflation

Currently 40%; likely to rise to 70% by Nowruz
vs. IMF estimate: 21.6% (by March 2012)
vs. Official figure: 20.6%

Liquidity growth
21% (Official estimate)

Unemployment
Over 35% in much of the country
vs. Official figure of 11.5%

Exchange Rates
USD:Rial
CBI figure: IRR11,290:USD1
vs. Unofficial/Black-market figure: IRR23,000:USD1
New Target: IRR50,000:USD1

Gold
USD 505 for an old coin (equivalent of USD 2,151 per ounce)
vs. International market price: USD 1,673 per ounce