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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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'Negotiators: The future of the Iranian economy is in your hands'

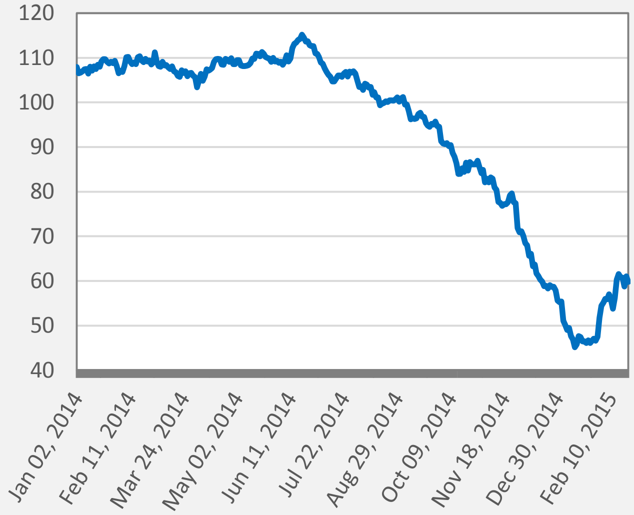
VerityIran predicted in November 2014 that the seven month extension to nuclear talks was really a four month chance to prove to conservatives in Washington and Tehran that a comprehensive deal would be possible. Those four months expire at the end of March. Two diametrically different economic trajectories lay ahead. In the next month we are likely to find out whether the future of the Iranian economy is one of resurgence or regression.

Fig 1. TEPIX All Shares index
01 Oct 2014 to 26 Feb 2015

If Iran's negotiators succeed in striking a comprehensive deal, Iranian businesses and citizens will see early and large dividends. Good news on sanctions removal will rapidly rebuild the value of the rial and the stock index, as markets prepare for the flood of repatriated funds from overseas accounts. The exchange rate effect will reduce inflationary pressure through import prices, freeing up some room for monetary and fiscal policy to boost demand again. Iranian exporters, for years in the doldrums as they navigated complex shipping and banking restrictions, will find themselves open for business and highly competitive: Iran's exporters will benefit from a much cheaper exchange rate than pre-sanctions. Within months, Iran will begin to liquidate its enormous overseas currency holdings and put them to use in the domestic economy, not least to buffer the impact of the drop in oil revenues. This is not to suggest such a scenario would not present its own challenges. A recent study by the Iran Fara Bourse pointed to the pressure on the CBI to manage responsibly the very large foreign exchange inflows that would result from sanctions relief, without inflating prices. Similarly, the problems of economic imbalances, irrational welfare systems, creaking infrastructure and a weak banking sector - to name but a few - would remain. But they would be much easier to handle with access to hundreds of billions of dollars of hard cash and the keys to international markets.

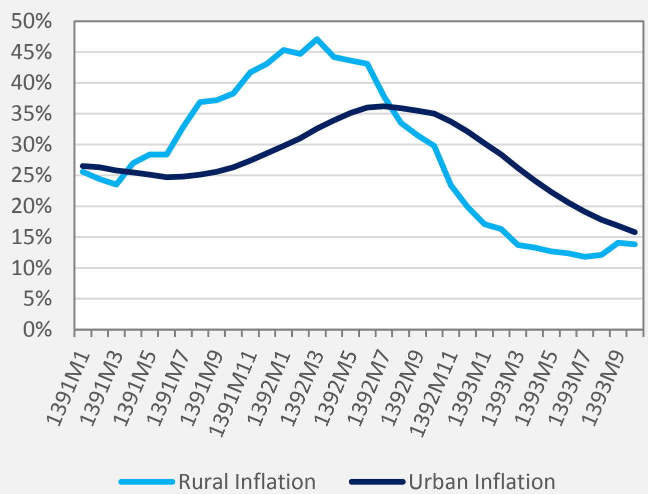
If we reach April with no clear promise of a deal, then the future for the Iranian economy looks inescapably grim: in the worst case, catastrophic. In the event of a collapse in talks, VerityIran economists expect an immediate shockwave to ripple through Iran's capital markets and the rial exchange rate. As witnessed in previous episodes of (less severe) financial isolation, we would expect to see a spike in capital flight and desperate attempts by the Central Bank to restrict capital flows and the availability of foreign exchange. Investment and consumer spending would seize up, just as fiscal austerity becomes a long term reality. This would contribute to a sharp contraction in aggregate demand that would send the economy back into negative growth. Thousands of businesses that have kept operations going in the hope of sanctions removal would close down. Every one of Iran's major banks, which are already technically insolvent, would be suddenly at acute risk of bankruptcy. The economic administrators that have capably steered the economy onto a more stable footing over the past 18 months would be forced to balance the principles of prudent monetary policy against intense political pressure to boost liquidity and finance government deficits. VerityIran believes the political pressure would be overwhelming and would herald a new period of heightened inflation just as growth is stalling. Meanwhile millions of ordinary Iranian households would see their real incomes further eroded as crisis loomed. A grim scenario indeed.

Fig 2. Brent crude oil price
01 Jan 2014 to 26 Feb 2015



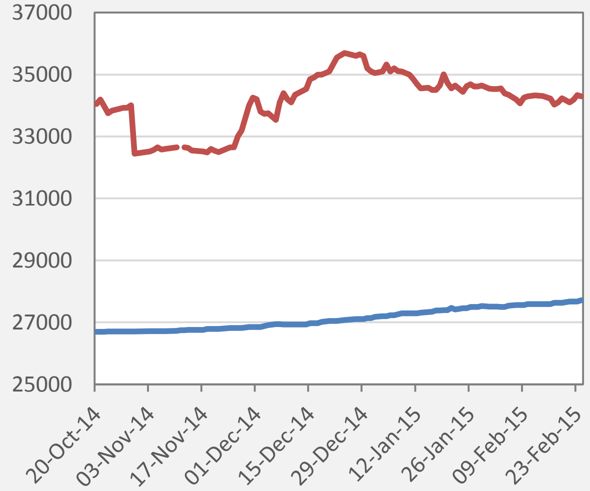
Iran is desperately trying to line up foreign investment into its ageing oil fields in the event of sanctions removal, but the state of the oil market is forcing ever greater concessions from Tehran. The Oil Ministry has reportedly been offering far more favourable terms to foreign investors than previously. In a country where foreign ownership has long been outlawed, Tehran is now offering prospective foreign partners involvement in production rights and greater control and certainty over long term revenues. ***But VerityIran sources suggest that the break-even price for digging new wells in Iranian fields is estimated at around US$120 per barrel, higher than elsewhere in the region as a result of years of underinvestment in new technology***. Even those most optimistic about the political trajectory will have profound doubts over the profitability of such an investment and would require extremely favourable terms to initiate large-scale investments quickly.

Fig 3. Urban vs Rural inflation
Consumer Price Indices, Azar 1391 to Bahman 1393



With the future of the economy in the hands of Iran's political masters, the Central Bank of Iran remains responsible for preparing the economy for either eventuality. The Deputy Governor was keen to manage expectations regarding the Bank's ambitious inflation target for 1394 of 13-14%. He stated that bringing inflation down even further from current levels will be a very difficult task and will require real monetary and fiscal disciple. The money supply (liquidity) grew 24.1% in the past year (point to point). Meanwhile the 12 month inflation rate (based on the Consumer Prices Index) has been brought under 16%. Fig 3 charts the progress made under the official measurement of inflation in the urban and rural context over the past 18 months.

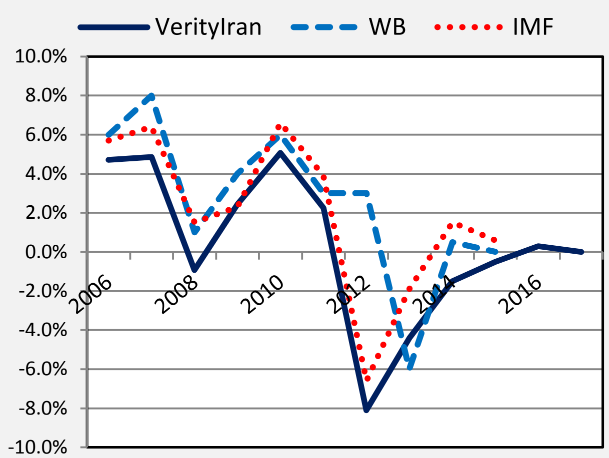
Fig 4. Official Rial/USD exchange rate (blue/bottom) vs Market rial/USD exchange rate (red/top)



The Central Bank also announced its plans to unify the official and market exchange rates. The dual exchange rate has become a fiscal burden, an inefficient allocation of resources, a channel for corruption and an effective tariff on many of Iran's non-strategically essential industries. VerityIran economists have long argued the logic for unifying the rates, but believe the timing is fanciful with such uncertainty and volatility surrounding the exchange rate in the coming months. Fig 4 reveals the substantial gap between the two rates.

In addition, the Central Bank released some key figures on the dire state of the banking sector. Banking debt to the Central Bank rose 36.5% to 77 trillion Rials (US$31bn) compared to the same month last year. The number of bounced cheques in the first nine months of 1393 was up 35.1% compared to the same period last year, amounting to 4.5 million cheques. Meanwhile the Economy Ministry's Audit Organisation said the total value of the banking system's non-performing loans, including interest and fees, has now reached 93 trillion tomans, equivalent to US$37.2bn. Early this year, Rouhani's economic advisor, Torkan, valued NPLs even higher at closer to 160 trillion tomans, which by our calculation was over half the value of total bank loans.

Fig 5. Historic GDP growth estimates and forecasts 2006 to 2017, IMF, World Bank, VerityIRan



As the Majlis spent another month picking over the government's budget proposals for 1394, a Central Bank report detailed the extent of the ongoing budget deficit. For the first nine months of 1393, government spending was estimated to have outweighed revenues by 10.8 trillion rials (US$4.3bn). The deficit is equal to around 9.3%, which contrasts sharply with the IMF's recommendations for fiscal prudence. Given the prevailing environment, the IMF recommended running a fiscal deficit no greater than 2.5% in order to contain inflation. The scale of the task to reduce spending is enormous, not least for the ferocity of the political battleground. The Majlis Deputy Speakers commented that there were one million surplus workers in government bodies, draining the government purse. Meanwhile after another month of fierce debate, the Majlis finally accepted the government's reasoning for maintaining Targeted Subsidy Law compensation payments to all – it simply does not have the data or the capability to means test the distribution of the cash hand-out. So this huge hangover spending commitment from the

Ahmadinejad administration is here to stay. In more positive news, the Government announced it had successfully privatised over US$1bn worth of shares in state holdings in 1393, which will have helped finance spending.

The World Bank and IMF substantially downgraded their growth estimates for the Iranian economy this month, dealing a further blow to confidence. These two entities have traditionally held a relatively rosy view of Iran's economic trajectory under the past administration, turning a blind eye to data manipulation and policy contradictions. Despite that, the depressed oil market and uncertainty over nuclear talks led the IMF to adjust its forecast for 2015 GDP growth from 2.2% to 0.6%, and the World Bank to downgrade its forecast to 0% growth for 2015. Fig 5 compares the IMF and WB estimates of Iranian GDP from 2006 to 2017, cast against VerityIran estimates. In the same update, the IMF estimated that Iran's external reserves will reach the unprecedented figure of US$130bn – a timely reminder of the size of the prize should Iran successfully reach a compromise with Western counterparts over the nuclear issue.