

# VERITYIRAN.COM

LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY



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## Issue 22 – May 2013

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### May overview

#### *Stable Rial masks economic decline*

The 'open market' value of the Rial remained relatively stable at about IRR 35,500 to USD 1 for most of May, following the sharp fall after the failure of the Almaty talks in early April. Judged by other economic indicators, however, it is clear that the economy is in severe decline:

- Inflation has continued to rise. Official estimates suggest that prices overall in March/April were up 38.7% on the same period in 2012, comfortably the highest inflation rate in the world. Unofficially, even the most conservative estimates suggest the rate is nearly double that, and expected to rise further.
  - The Islamic Republic of Iran Shipping Lines (IRISL) announced a sharp drop in revenues from USD 2 billion to less than USD 1 billion. IRISL blamed sanctions, as well as the world economic slump for the fall.
  - The Government's draft budget (at time of writing still not approved by the Majlis) embodies a sharp fall in Government spending, and forecasts lower oil revenues.
- A report by the Majlis Research Centre suggests that the Iranian economy is likely to contract again this year. It projected a range of growth of between -4% to 0.75%. Without substantial sanctions relief, VERITY expects the economy to contract over the next year by more than 5%, with contraction by 8 or 9% a distinct possibility.



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*Election*

The Guardian Council approved 8 candidates to stand in the election. The two most controversial candidates, Rahim Mashaei, an ally of outgoing President Ahmadinejad, and ex-President Hashemi Rafsanjani, were disqualified.

With the disqualification of Rafsanjani went the best prospect for a settlement between Iran and the UN on nuclear issues. The most likely victors now appear to be Ali Akbar Velayati, advisor to the Supreme Leader, and Said Jalili, nuclear negotiator and head of the Supreme National Security Council. Neither candidate appears likely to deal with the UN, or to offer radically different policies on the nuclear file. Some bazaaris are predicting price increases in the near future.

Rafsanjani's disqualification also removes from the field a candidate with a credible record for economic management. As president in the 1990s, his administration was credited with pursuing sound economic policies that resulted in growth. However, the reality for Iran today is that Iran's economic problems are too entrenched to be fixed by better economic management alone. President Ahmadinejad's departure offers hope, but sound economic policy is not a panacea for Iran's economic woes. Unless sanctions can be overturned, the prospects for real and sustained economic improvement remain dim.

*New US sanctions*

US lawmakers have begun debating new sanctions legislation this month. The new legislation seeks to limit Iran's oil exports to less than half a million bpd, to further limit Iran's access to foreign currency, and to expand the list of blacklisted sectors of Iran's economy. The looming threat of additional sanctions on its economy will further restrict the room the next Iranian administration has to turn the economy around. A nearly impossible task looks fast to be becoming simply impossible.

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## **Sanctions damaging trade with India and Turkey**

The long-term impact of the current sanctions on the Iranian economy is becoming increasingly clear. As VERITY has reported frequently, Iran's trade partners are abiding by sanctions, cutting trade with Iran and seeking to do business elsewhere. Even presidential candidate Velayati, adviser to the Supreme Leader, has acknowledged the effectiveness of sanctions. In a televised interview, Velayati publicly stated that Iran is currently unable to collect about USD 30 billion of oil payments from China and a similar amount from India.

Reuters has reported that Indian imports from Iran fell 34.2 % between April and March 2013. Compared to the same period in 2012, Indian imports were down 56.5%. Against a background of increasing Indian oil imports (up 10% compared to last year), Indian demand for Iranian oil is dropping as oil importers try to avoid falling foul of US restrictions, and find it difficult to obtain shipping insurance for cargos of Iranian oil. Mangalore Refinery and Petrochemicals Ltd and Hindustan Petroleum Corp Ltd declined to make fresh purchases of Iranian oil as a result of concerns about obtaining adequate insurance.

VERITY has learned that Turkish oil firm TUPRAS is planning to decrease oil purchases from Iran to around 80,000 bpd. Meanwhile, Turkish Halk Bank appears to be abiding by US restrictions. Halk Bank has not processed 3rd party oil payments for Iran since the restrictions were introduced on 6 February 2013. Iran has yet to find an alternative avenue for processing 3rd party oil payments on anything like the scale previously provided by Halk Bank. Its ability to repatriate oil revenue in sufficient volumes is severely constrained as a result.



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## Hard currency shoring up value of Rial

The Iranian Government has been importing hard currency from regional countries and gold from Turkey to stabilise domestic gold and exchange markets. The Government's aim is to keep the open market value of the Rial steady at IRR 35,000 : USD 1, and to prevent further large drops in value.

Despite a dip in value at the end of May, it would appear that the Government's aim has been broadly met this month, albeit at the expense of reducing the trade in essential goods at the CTC rate. It is equally clear, however, that the fundamental problem of a shortage of foreign exchange has not been solved. Given this, the uncertainty surrounding the election and the policies of the next administration, and the introduction of new US sanctions on the economy, the exchange rate position is extremely uncertain. Absent any major shocks, VERITY expects the headline free-market rate to remain broadly stable, in the region of 35,000 to 38,000, but for increasingly fewer goods to be available at the CTC rate.

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## Inflation expected to reach 90%: official estimate

VERITY has learned that inflation is set to rise higher as the CBI is further increasing the rate of money supply growth. Inflation is officially expected to rise to approaching 90% during the summer. High and rising inflation is damaging economically and socially. High inflation prompted the Majlis to convene in an emergency closed session in early May, with some concerned about the risk of popular unrest. There is already widespread impoverishment; significantly higher inflation will increase the prospects of real internal pressure on the regime.

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## CBI bails out Iranian banks

Non-performing loans and the currency devaluation are storing up problems for Iran's banks. The value of savings in Iranian banks fell dramatically last year. Many Iranian banks are technically insolvent, and have been for some time. However, banks will continue to abstain from foreclosing on loans for the foreseeable future, as the possible effect of such foreclosures on the economy and stability of the financial system would be deeply damaging.

Iranian Banks, Bank Maskan and Bank Tejarat, have incurred substantial debts to major Japanese trading companies, and had to be bailed out by the CBI in April 2013. The CBI agreed to pay up immediately to try to limit the damage to Iran's credit rating with trading partners in Japan, and across Asia more widely.

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## Poor forecast for Iranian natural gas and LPG exports

Domestic demand for Iran's plentiful natural gas reserves is growing. Over 3 million natural gas powered cars are on the road in Iran, more than in any other country, as consumers reap the benefit of their lower fuel costs. It is an environmental, engineering, and domestic production success. However, prospects for Iran's natural gas industry beyond its borders are not so bright. Due to UN, US, and EU sanctions, Iran has been stifled in its efforts to expand in



international markets.

In 2010, Iran held the second largest national gas reserves in the world, behind only Russia. Since then, as improved fracking technology made shale gas extraction easier, access to global reserves expanded dramatically. Thus, while Iran struggles to develop the huge South Pars field – a process also hindered by sanctions – its reserves and production are being rivalled and even surpassed by those of Canada, the US, and Argentina. Greater accessibility has further depressed prices.

With international sanctions limiting exports of natural gas, Iran has reduced production of exportable products. Compare that to Myanmar, also a home to large natural gas reserves, which once faced stiff international sanctions, but has seen them lifted over the past year. China and India, traditional markets for Iranian oil and gas, are seeking pipeline agreements with Myanmar. If completed, they would mark a serious impediment to Iranian gas companies trying to break into these markets.

The longer Iran is out of these markets the more difficult it will be to re-enter. Once Iran can bring South Pars online, it should concentrate on domestic use of the natural gas, and it will likely be forced to find export revenues elsewhere.

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## **VERITY Investment Focus: Private Iranian Banks**

Private Iranian banks were once excellent investments. Prior to sanctions, Bank Eghtesad Novin (ENBank), with a return-on-equity (ROE) of more than 30 percent, and Bank Pasargad, with a ROE of more than 27 percent, were more profitable than any of the large global banks. By comparison, major US and European banks during this period typically had ROEs in the 10-15 percent range.

Some Government measures to mitigate sanctions effects could potentially help the banking sector (higher interest rates, for example). However, Iran's declining economic activity will hurt banks by reducing demand for loans. In addition, there is little information about the current quality of their loan portfolios, and given Iran's economy, they likely hold a high rate of non-performing loans. This is a situation demanding investor caution until international financial sanctions are relaxed.

If sanctions were to be resolved and Iran was to become integrated into the global economy, private Iranian banks should again present excellent investment opportunities. They are well positioned in the Middle East region as well as other countries requiring Islamic banking expertise. The relatively low capital requirement for the banking industry suggests that Iranian banks would be able to recover from the current economic trauma faster than the more capital-intensive Iranian industries.

### **Statistics**

#### **GDP Growth**

2013: -1.3 (IMF estimate for 2013)

#### **Inflation**

Estimated at c.77% across Iran vs. Official figure: 38.7%

#### **Unemployment**

Between 30-35%



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vs. Official figure: 14.1 %

**Exchange Rates**

Rial:USD

Currency Centre rate: IRR 24,500:USD 1

Vs Unofficial rate: c. IRR 36,500: USD 1



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