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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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Rial falls to record low as CBI reduces the flow of currency to the market

International financial sanctions, economic mismanagement, and loss of investor confidence have combined to send the Rial into free-fall. The IRR:USD exchange rate surpassed its historic low in late September when it fell to IRR26,000:USD1; however, this was only the beginning of the bad news for Iranian investors. Unlike in past months, the Central Bank of Iran (CBI) has been unable to take effective action to stabilise its currency which continues to lose value on a daily basis. At the time of going to press, the Rial was trading on the open market at as little as IRR36,000:USD1 as those with Rial holdings rushed to convert their investments into property, gold, and stable currencies.

As VERITY predicted in our last issue, the fall was due principally to the CBI being forced to reduce considerably the amount of money it injects into the market daily, a move which was confirmed by the Head of Iran's Parliamentary Budget Committee Gholamreza Mesbahi Moghaddam.

VERITY has learnt that CBI officials have been forced to reduce the amount it injects daily into the market by tens of millions of dollars as this is the only way the CBI can continue to supply the market without depleting foreign currency reserves to dangerously low levels. Officials assess that even the current rate, estimated at between USD 35-45 million per day is likely to be unsustainable and further reductions will be required over the coming months.

Government officials have accused speculators of manipulating the currency market and stressed that the loss of investor confidence is mainly psychological and does not reflect the Rial's true value. VERITY sharply disagrees:

With the Rial's value falling daily, investors are bearing the consequences of the impasse in negotiations between Iran and the international community over Iran's suspect nuclear ambitions. With no settlement on the horizon, there is no reasonable option available to investors other than ***converting the maximum amount of Rial holdings possible with immediate effect*** *into more stable assets. Investors are advised to* ***act quickly*** *before further capital controls are* *imposed on the currency market and banks*

VERITY's prediction for the Rial

- We see no possibility beyond the short-term of a sustainable rally in the value of the Rial and our only question is when, and how quickly the Rial will fall further: Will the shock which began in September continue? Or will the Rial decline more steadily over the long-term?

- Although economists within the CBI are likely to propose a steady, managed depreciation of the Rial, the current Government is likely to prefer trying to stabilise the Rial at around IRR35,000:USD1. However, unless the Government can find a solution to the problem of the acute shortage of FX, we see no possibility of the CBI being able to restore investor confidence and maintain stability of the Rial beyond the short-term.

- The CBI is likely to maintain a much stronger official exchange rate for essential commodities to maintain public stability, but the accessibility of this official rate will be far more limited.

- Fears of hyperinflation are exaggerated: Iran still receives substantial oil revenue despite this being sharply reduced over the last 12 months, and despite much of it now being bartered. However, with the recent Rial devaluation and more to follow, it is inevitable that inflation will rise sharply, possibly into triple digits.

- Our recommendation remains that investors, in the short-term, ***withdraw the maximum amount*** *of their Rial holdings, and convert them to more stable assets such as gold, property, and reliable foreign currencies such as USD and Norweigan Krone.*

Major re-shaping of the Iranian economy under way

Recent public statements and interviews by both Supreme Leader Khamenei and President Ahmadinejad, combined with September's exchange rate fall, suggest to VERITY that a major re-shaping of the Iranian economy is under way.

Since coming to power in 2005, Ahmadinejad, taking advantage of prudent investment in oil infrastructure projects implemented during the Khatami presidency (1997-2005), together with record highs in the oil price, has been able to use substantial oil revenues to finance an import-led boom in the Iranian economy. With the acute contraction of oil revenues in 2012 this model is effectively broken. With oil revenues likely to remain significantly depressed in the short to medium-term, investors need to look carefully at re-balancing their portfolios.

Our strongest advice remains that investors look to convert their Rial holdings into safer, more reliable assets both in and outside of Iran. We continue to advise against holding stocks in import dependant industries; we also see particular risks to Iranian agriculture, which will be hampered by Government efforts to ensure core food price stability – whether through subsidised food imports or government control over food prices and potential rationing.

An Opportunity for the Banking Sector?

Although the economic outlook for investors in Iran is increasingly bleak, there remain opportunities for bolder investors willing to risk their money on the possibility of the Iranian government taking measures to break the impasse with the international community over Iran's nuclear programme resulting in the loosening, and in some cases lifting, of international financial sanctions.

During the past six years Iran's banking system has become increasingly isolated, leading to a decline in the profitability of the banking sector. We have repeatedly issued liquidation of holdings recommendations on Iran's banks since the stresses of the last several years have pushed banks into negative balance sheets. If the government's policies do not change, Iran's banks will become increasingly less viable. Without sanctions, Iran's banks would have a competitive advantage, as they have been relatively insulated from the effects of worldwide economic problems on global banks.

Many US and European banks suffered deep losses from the mortgage crisis and continue to liquidate these holding at a loss. In addition, they face serious regulatory and criminal investigations for manipulating the London Interbank Offered Rate (LIBOR) and for allegations of money laundering. The combination of self-inflicted damages will create an opening in the next year or so for banks outside the traditional global network. Iran's banks are well positioned to return to markets in the Middle East and Europe. Prior to the imposition of sanctions, Iran's banks were among the most effective in the region, suitable for the Middle East, which will require sophisticated banking products once the global banks are forced to retrench.

Competitors from Australia, Canada, and neighbouring Qatar will be moving to fill the vacuum. If Iran's banking sector wishes to take advantage of this new opportunity, it will have to act quickly.

Recommendations:
- *If no change in government policy continue to* ***liquidate holdings***

- *If government changes policy and sanctions eased* ***strong buy recommendation***

Iran's oil exports recover slightly in August; will this last?

Following the initial shock caused by new US and EU sanctions in July and August, Iran's oil exports fell sharply to below 1 million barrels per day (mmbpd) in July, before improving slightly to around 1.1 mmbpd in August. This improvement was due largely to a 400 per cent month on month increase in exports to Turkey.

Export volumes are likely to increase moderately over the coming months as buyers such as South Korea and Sri Lanka recommence their import of Iranian oil following their acceptance of Iran's offer to provide insurance for the tanker transport. However this moderate increase is likely to prove temporary; the waivers granted by the US to importers who demonstrated a substantial reduction in imports of Iranian crude oil in July will have to be renewed by the end of 2012 and the US is likely to demand further substantial reductions.

It is still unclear whether oil export revenues will recover more strongly than export volumes. Though oil prices remain historically high, and uncertainty over military action against Iran is likely to cause periodic surges to prices, the combination of continued weakness in the global economy and the effect of international sanctions is likely to prevent Iran's monthly oil export revenues from recovering far from their July lows.

Generating revenues from crude oil exports has become doubly problematic for Iran; not only are exports down significantly since the beginning of 2012, but of the oil exported, Iran is only able to receive payment for about a third, usually on the basis of Letters of Credit. Buyers of Iranian oil are using Iran's problems to their advantage by demanding discounts of around USD 5 on each barrel purchased. Analysts have suggested that Iran's yearly income from crude oil exports will fall by around USD 50 million in 2012 compared to 2011.

Statistics

GDP growth
-2% (2012 best case estimate)
vs. CBI: 5.8% (1389)

Inflation
50% +
vs. Official figure: 23.5%

Liquidity growth
21% (Official estimate)

Unemployment
Between 25-35% and rising
Vs. Official figure: 14.1

Exchange Rates
Rial:USD
CBI figure: IRR12,260:USD1
vs. Unofficial rate: IRR36,000:USD1