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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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June overview

New President; tough old challenges

Hasan Rouhani, a moderate, won Iran's presidential election on 14 June, after the first round of voting. He is due to assume power on 5 August, following a period of transition and subject to when the Eid holiday falls. In the intervening period, Rouhani will choose his ministers. He has promised to appoint experts and academics to key positions within a 'government of prudence and hope". Rouhani's choices will be put to the Majles for approval within 2 weeks of taking office; he has already held discussions with Speaker Larijani to discuss co-operation.

President-elect Rouhani takes up his appointment at a time when Iran is facing tougher economic challenges than it has faced at any time since the end of the war with Iraq. The policies and mismanagement of his predecessor, Ahmadinejad, has left Iran with some of the highest inflation in the world, high and increasing unemployment, and a population largely dependent on government subsidies to buy basic goods. Iran's vitally important energy sector, and particularly its oil industry, is suffering from decades of underinvestment and declining exports. The recent drop in the price of oil to below USD 100 a barrel will add further strain to the Iranian economy.

Above all else, suspicions about Iran's nuclear programme and foreign policy, including a costly war in Syria, have isolated Iran internationally. Sanctions imposed by the UN, the EU, and unilaterally by the US and a range of other countries, have cost Iran trading partners, frozen tens of billions of dollars of foreign reserves, and blocked routes to economic recovery. Neither the nuclear programme, nor foreign policy is likely to be within Rouhani's power to change. The Supreme Leader made that much clear during the campaign. Yet without resolution, the international community, and particularly the US, are unlikely to be willing to lift sanctions and invite Iran back in from the cold.

Rouhani will prioritise economic recovery. But with little executive experience himself, a budget (finally passed on 12 June) constrained by the fall in oil revenue, a requirement to clear major economic decisions past the Committee for Special Measures to Control Sanctions (chaired by conservative election rival Sa'id Jalili), and one hand (if not both) tied by the intransigence of both the Supreme Leader and the West on the nuclear programme, Rouhani's ability to deliver recovery will be severely limited.

Rial improves against the dollar

In the days following Rouhani's election, the 'open market' value of the Rial against the dollar rose considerably. From a starting point of IRR 36,450 at the beginning of the month, some dealers were offering prices below IRR 30,000 in the days and weeks following the election. Post election euphoria and optimism that things will now improve have contributed to an artificially inflated value. VERITY expects the value to drift as things begin to settle, and the true, limited, extent of Rouhani's ability to effect change in key areas of policy becomes apparent. Aside from a possible spike around the time that Rouhani is sworn in, VERITY predicts the value of the Rial will return to its pre-election value by the autumn, with the possibility of further devaluation thereafter.

Tightening US sanctions

The US, in early June, introduced a range of new sanctions against Iran. The new measures targeted Iranian petrochemical companies, the automotive industry and more than 50 Iranian officials. The new sanctions threatened foreign banks that trade or hold Iranian Rials with heavy penalties should it make those Rials accessible to Iranian or Iranian linked entities. The US Treasury also identified 37 companies internationally that it said operated as front companies for the Iranian leadership.

The announcement of these new measures was rather lost in the noise surrounding the election, and the full impact of these new sanctions will take time to be realised. But they will reduce the room available to Iran's leadership to effect an economic recovery. Although enacted before the Iranian election, the US have made no efforts to lift the sanctions following Rouhani's victory. The pressure on Iran, from the US at least, appears set to increase absent any movement from Iran in the nuclear negotiations.

Jump in Chinese oil imports

Iranian exports of crude oil jumped more than 65% between April and May, from 835,000 bpd to 1.39 million bpd, according to the International Energy Agency. The increase was largely down to a doubling of Chinese imports to 715,000 bpd. Chinese imports account for more than 50% of Iranian exports in May. The increase in Chinese imports was not unexpected, however, as congestion in China's ports had limited the volume of Iranian oil China had been able to import in recent months.

Analysis of Chinese imports on a month-by-month basis can be misleading; experts tend to examine imports over the six-month periods between US waivers. The trend, over successive 6 month periods since US sanction were introduced on 1 January 2012, has been of small percentage decreases in Chinese oil imports. At the same time, Chinese energy demands have increased and diversified. Imports from other oil suppliers, including Iraq, Russia and Venezuela have increased.

On 5 June, the US agreed to renew the six-month waiver on Iran sanctions for China. In exchange, China (as well as India and seven other countries that also had their waivers extended) agreed to continue to reduce purchases of oil from Iran. Looking ahead to the next six-months, VERITY expects the Chinese to continue to reduce the total amount of oil imported from Iran by just enough to secure the next US waiver.

Shrinking CBI reserves

According to the latest figures seen by VERITY, the CBI's reserves of foreign currency are shrinking at an alarming rate. As reported last month, the CBI is injecting foreign currency to shore-up the value of the Rial. VERITY has clarified that this amounts to more than USD 15 million every day. Over time, this has shrunk the size of Iran's accessible hard currency reserves to less than USD 20 billion. With pressure on Iran's economy likely to remain or increase, and Iran unable to access about USD 100 billion in overseas accounts, some analysts are predicting that Iran's accessible foreign currency reserves will not last much longer than 12 more months. In addition, the decreasing value of gold means that Iran's gold reserves are now worth less. At current levels, Iran will be unable to sustain its current level of expenditure on imports.

Internal report predicts value of Rial will fall

The legacy of the CBI's efforts to keep the value of the Rial steady against the US Dollar through mid 2013 are likely to haunt the new Iranian administration. Although the Rial was relatively stable before the election, at about IRR 36,000 : USD 1, the effort to keep it stable, at a time of high inflation, tightening sanctions and reduced oil income, exhausted Iran's reserves. An internal report seen by VERITY has predicted that the value of the Rial will fall sharply after the election, to approach a new low. As stated above, VERITY predicts the value of the Rial will return to its pre-election value by the autumn, with the possibility of a further devaluation thereafter.

Loss of Indian imports could cost USD 5 billion in lost revenue

Insurance issues have continued to deter Indian companies from importing Iranian oil. Several major Indian refiners have decided not to make future purchases of Iranian oil; others have decided to make large cuts to imports from Iran. The Indian Government has publicly discussed plans to set up an insurance pool, to be managed by the General Insurance Company (GIC), but the pool has not yet materialised. Whilst the Petroleum and Natural Gas Ministry appears willing to contribute a significant amount into a pool, the Financial Services Secretary has recently dismissed clams that a sovereign guarantee for the insurance pool will be provided.

Unless the Indian Government is able to offer adequate insurance, industry analysts have suggested that the loss of sales associated with this development would account for a reduction of almost 10 percent of Iran's total export volumes. Analysts have indicated that a 10 percent reduction would be worth nearly USD 5 billion per year in lost revenue to Iran.

Naftiran Intertrade Company owes USD 1.5 billion to contractors

New evidence has emerged of the continuing impact of existing sanctions on Iran's oil industry. In April 2013, debts owed by the Switzerland-based Naftiran Intertrade Company (NICO), a designated front company for Iran's National Iranian Oil Company (NIOC), to its contractors, a range of companies from across the Middle East, India and Far East Asia, totalled about USD 1.5 billion dollars.

Set up to help sell Iranian oil to European markets, NICO's debts demonstrate the degree to which those markets are closed to Iranian oil, following the enforcement of the EU oil embargo in July 2012. With NIOC's ability to bail-out NICO constrained by the declining oil exports, and the scale of NICO's debts, it is unlikely that NICO will continue to be able to operate in Europe for much longer.

MFA budget cuts

A combination of a shortage of foreign currency and high inflation is likely to severely constrain Iran's diplomatic activities. While the overall appropriation of Rials by the Ministry of Foreign Affairs (MFA) increased this year, a cut in the MFA's foreign currency allotment, which is used by MFA officials overseas to purchase foreign currencies and pay for mission expenses, amounts to a reduction of more than 65% in their budget.

The cut in the MFA's foreign currency allotment is further evidence of the impact of the shortage of foreign currency in Government. While the size of the cut is unlikely to be significant in terms of the Government's total foreign currency reserves, the cut is likely to restrict the activity of MFA diplomats overseas. It may result in the closure of MFA offices, as the MFA are forced to consolidate their presence overseas. Fewer MFA offices will make it more difficult for Iranian businesses to expand into new markets.

Fujairah closed to NITC traffic

UAE authorities on 29 May issued an amended Note to Mariners (NTM) which stated that Tankers classed under non-IACS (International Association of Classification Societies) would not be permitted to perform oil cargo operations in the Port of Fujairah. The NTM effectively closes the Port of Fujairah, one of the largest ship refuelling and bunkering centres in the world, to all Iranian Tankers. The National Iranian Tanker Company (NITC) now faces significant additional costs as its vessels are forced to seek alternative ports for crew changes, repairs, inspections and dry-docking.

VERITY Investment Focus: Iran's Natural Gas and Electric Power Investments

Iran's enormous natural gas reserves, roughly 15% of the world total, are arguably its most important strategic economic asset. Yet delivery constraints and sanctions have prevented Iranian natural gas from realizing its full economic potential. Iran lacked liquefied natural gas (LNG) facilities or delivery pipelines prior to sanctions, which have further dimmed prospects for their construction.

A more realistic move for Iran would be to use natural gas to sell electric power, as it costs less to build transmission lines than natural gas pipelines. Publicly traded companies providing equipment and services for what would be a large expansion in Iran's electric power production would then present excellent investment opportunities.

As the result of joint power plant ventures over the past two decades, Iran has developed the engineering and manufacturing capability to build non-nuclear electric power plants with minimal foreign help. This expertise is most notable in the MAPNA Group (Tehran Stock Exchange: MAPN1), a large technical conglomerate capable of constructing modern gas-fuelled power plants in Iran and throughout the Middle East. MAPNA would be expected to profit greatly from a large expansion of Iran's electric power sector.

Sanctions severely limit Iran's ability to sell electric power to neighbouring countries but this energy sales strategy should be expected to develop quickly once sanctions are eased.

Statistics

GDP Growth
2013: -1.3 (IMF estimate for 2013)

Inflation
Estimated at c.77% across Iran Vs. Official figure: 42.2%

Unemployment
Between 30-35%
vs. Official figure: 14.1 %

Exchange Rates
Rial:USD
Currency Centre rate: IRR 24,500:USD 1
Vs Unofficial rate: c. IRR 31,500: USD 1