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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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October overview

A summary of the top Iranian finance news stories from the last month:

E3+3 talks in Geneva fuel rising stock exchange

The latest round of nuclear talks between the E3+3 and Iran occurred in Geneva, Switzerland, on 15-16 October. These were the first talks between the E3+3 and representatives of President Rouhani's Government. Foreign Minister Zarif led for Iran. The content of the discussions has been kept confidential, which some analysts have suggested is a sign that serious negotiations are beginning. The convening of a joint press conference between Zarif and Baroness Ashton, the EU's head diplomat and chair person of the E3+3, at the end of the talks has also been described as an indication of progress. A further round of talks is scheduled for early November.

In spite of the efforts to keep discussions out of the media, some details have emerged, such as what the 'end state' of Iran's nuclear programme should look like. If true, this would represent the first time that negotiations have looked beyond first-step confidence building measures, and would be a sign of progress. In E3+3 capitals, press reporting has been broadly positive. Reports have described a change in tone from Iran, and off-the-record briefings have suggested constructive dialogue from all parties.

The market has continued to respond positively to signs that Iran may be starting to move out of international isolation. The Tehran Stock Exchange main index (the Tedpix) reached a high of 74400.2 on 19 October, up 4 percent since the talks began, and 43 percent since Rouhani's election on 15 June. The market fell back a little after 19 October, reaching 72215 on 28 October.

For some, the rise of the Tedpix has led to fears that it is being fuelled by unrealistic expectations of a quick deal on the nuclear programme. Despite the improved atmospherics on both sides during the latest round of talks, it is clear that significant obstacles remain to a deal on the nuclear programme. In Iran, elements within the powerful IRGC, whose conglomerates dominate the industrial sector and whose leadership retains the ear of the Supreme Leader, are believed not to favour a nuclear deal. In the US Congress too, there is opposition to any deal that stops short of a complete ban on Iranian enrichment, something which is unlikely ever to be acceptable to Iran. Minister of Economy, Ali Tayebnia, said in early October that any hope for the lifting of sanctions in the near future was "wishful thinking".

Moreover, even if a deal could be struck in the near-future, it would take a long time for Iran's economy to recover. Beset by years of sanctions pressure, underinvestment and mismanagement, it will be many years before Iran's critically important energy industry is in a position to start to realise the benefits of Iran's vast reserves of natural resources.

Investors will also be wary of over-optimism given the picture painted by Iran's wider economy. Rouhani has acknowledged that the economy contacted by more than five percent over the last year; without significant sanctions relief, this year could be as bad or worse. Officially hovering at around 40 percent, inflation is unofficially believed to be considerably higher. According to official figures, youth unemployment stands at about 26 percent (though is likely to be much higher in reality), and food prices in Tehran, including rice, grain, vegetables and vegetable oil, have shot up in the last year.

While there are reasons for cautious optimism about the outcome of the nuclear talks, a deal still looks a long way from being done. The market appears to be trading at an optimism premium, fuelled by the positive atmospherics between Rouhani's Government and the West, and an expectation that there will be substantive progress. Constructive dialogue is an important first step, but the hard part lies ahead. It is not yet clear that Rouhani can persuade the regime's hardliners, or the Supreme Leader, to compromise sufficiently for a deal to be struck with the West. Neither is it clear that the West, and in particular the US Congress, is prepared to live with an Iran that retains any form of enrichment capability. Iran's economic fundamentals are weak, and in many areas are still deteriorating. Time is not on Iran's side. Investors will be wary that Iran's bubble may burst. Investors could be badly exposed should talks break down, or a deal not materialise soon.

Iranian Government to slash cash handouts

In mid-October, the Governor of the CBI, Valiollah Seif, announced that the Government had agreed with the Majlis to reform the payment mechanism whereby 76 million Iranians have received monthly cash subsidies to help to cover the cost of energy and basic commodities. Plans, which were included in the draft budget presented by Rouhani's government, involve removing the wealthiest one third of the population from the scheme before the end of the Iranian year (20 March). The Majles approved the general draft of changes to the budget on 24 October.

Reform of the subsidies will be deeply unpopular within Iran, but officials have said that it is impossible to continue with the current level of payments. Rouhani's Government have prioritised reducing the budget deficit, which is (unofficially) estimated to be approaching USD 30 billion.

In early November, 100 days after taking office, Rouhani is expected to provide a detailed summary of the state of Iran's finances and his plans to turn the economy around. VERITY expects reform of the subsidies to be a key part of those plans.

More news

A round-up of news stories from VERITY's own sources that have passed under the news radar over the last month:

Macro economic news

TSE and currency perform strongly

The Tehran Stock Exchange (TSE) reached a new high of 74400.2 on 19 October, perhaps reflecting the positive media reaction to Iran's meeting with the E3+3 in Geneva on 15-16 October. The Iranian Rial also continued to perform strongly on the open market. After falling back from September's high of 29,600 to the USD, the Rial remained fairly steady at about 32,500 for much October. The value of the Rial had fallen to closer to 40,000 before the election in June.

More than USD 10 billion Iranian reserves missing

More than USD 10 billion of Iranian reserves held in overseas private bank accounts have gone missing, according to VERITY's sources inside Iran. The money was placed in private overseas accounts controlled by individuals or organisations trusted by the Iranian Government. It served as a liquid reserve, outside the restrictions placed on Iranian funds by international sanctions. The US and its allies have placed restrictions on much of this money, effectively freezing it outside of Iran. An undisclosed amount, however, is believed to have been hidden away or lost by those individuals tasked by the Government with looking after it. The Iranian Government has launched a series of investigations to verify what has happened to some of these missing funds.

Annual inflation rate exceeds 40 percent in August/September

The CBI announced on 8 October that the annual inflation rate exceeded 40 percent on most essential items in August/September. The cost of food and drink rose by 51 percent, shoes by 60 percent, and utilities, water and fuel went up by 21 percent. Health care and transport increased by 43 and 45 percent respectively. VERITY's own research suggests that the CBI figures significantly underplay the level of inflation in Iran. VERITY believes that inflation in Iran may be closer to 60 percent or higher.

Divide in Iranian Government over economic policy making

VERITY's sources have reported that a deepening divide is developing within Rouhani's economics team over economic policy making. Officials at the top of the CBI are reported to advocate a policy of printing money in order to offer immediate breathing space, and to tide Iran over whilst Rouhani seeks relief from sanctions and access to frozen reserves. Officials in the Finance Ministry, however, are concerned that printing money could raise the level of inflation even higher. Instead, Finance Ministry officials are reported to be supporting a policy of tax increases. Although likely to offer a more sustainable recovery in the long term, their critics have argued that tax increases offer no promise of improvements now.

Given the scale and urgency of the economic crisis, disagreements at the direction of economic policy are unfortunate, particularly so soon into the new administration's tenure. But they are, perhaps, not altogether surprising. By pulling together a range of experts and former ministers, Rouhani has put in place a team to provide him with some of the best advice on how to take Iran forwards. They won't always speak with one voice; with their range of backgrounds, disagreements are inevitable. Nevertheless, it will be an early test of Rouhani's leadership to choose the right course without alienating either group. Public fallings out over the direction of economic policy will, after all, pose a serious risk to Iran's fragile economic recovery.

'Reference' exchange rate no longer available for staple goods

A government directive issued in late October effectively removed the 'reference' subsidized exchange rate for imports of staple goods, including cooking oils, sugar, rice, butter, and livestock feed. The reference rate would continue to be available for imports of wheat.

Banking news

Weaknesses in banking industry revealed by outstanding trade finance commitments

VERITY's sources have unearthed further evidence of the debts owed by Iran's private banks. VERITY has learned that in August 2013, Iranian banks owed the equivalent of nearly USD 1 billion in outstanding trade finance commitments to Bank Melli's branch in Dubai. VERITY's sources have also revealed that as of late July 2013, Iran's outstanding Indian trade finance commitments with an Indian Bank was worth the equivalent of USD 80 million.

The level of indebtedness in Iran's private banking industry reflects weaknesses in the Iranian economy as a whole, and acts as a disincentive to external private investment. Rouhani has pledged to reform the banking industry, as part of his plan to strengthen the private sector in Iran. Investors will welcome details of this reform in Rouhani's 100 day summary.

Oil and Gas News

China intercepts shipment of Iranian oil to North Korea

According to a report in Japanese newspaper Asahi Shimbun on 20 October, Chinese authorities have seized a shipment of Iranian condensate bound for North Korea. Quoting Chinese sources, the report suggests that the shipment was part of a deal for North Korea to import 500,000 tons of condensate from Iran. Hitherto heavily reliant on China for its energy needs, North Korea had been attempting to diversify its energy sources. Deliveries of condensate to North Korea are not banned under UN sanctions. One diplomatic source was quoted as saying that China had seized the oil to maintain its influence over North Korea.

European refineries re-configurations pose long-term threat to Iranian oil exports

In September 2013, officials within the Iranian government continued to be concerned that international sanctions would have disastrous long-term consequences on Iran's oil sector. The officials recognised that Western companies were mixing crude oil from different parts of the world to use in refineries in Europe that had previously been configured solely to process Iranian crude oil. As VERITY has previously argued, the longer the sanctions prevent Iranian crude oil being sold, the harder it will be for Iran to re-enter the world market.

USD 4 billion one-year banking agreement between Iran and Syria

VERITY has learned that in order to meet the Syrian demand for crude oil and petroleum products, the Syrian Government have negotiated a one-year banking agreement with Iran that would extend a credit facility to Syria worth close to USD 4 billion.

Details of barter agreement between Iran and Syria

VERITY's sources have established the details of the barter agreement between Iran and Syria, for the provision of Iranian oil and oil derivatives to Syria. Iranian light crude oil is being provided to Syria at a discount of about 10% on the official price of Iranian light crude sales to customers in Europe and the Mediterranean. In return, Iran is importing Syrian heavy crude for onward export to its customers. Iran is offering the price it sells Iranian heavy crude to customers in the Far East minus roughly USD 5 per barrel.

Other news

Direct tax income increases 34 percent

Iran's direct tax income was up 34 percent in the first half of the Iranian year, compared to the same period last year, according to media reporting. Direct tax income was reported to amount to IRR 130 trillion in this period, which is the equivalent of USD 5.2 billion using the CTC exchange rate.

Low reserves of essential goods contributed to reintroduction of 'reference rate'

Low reserves of essential goods, such as wheat, barley and cooking oil, may have contributed to Iran's decision to reintroduce the 'reference' exchange rate, as reported in August's edition of VERITY. With winter approaching, VERITY's sources have revealed that Iran had enough wheat to last only three months at current consumption levels. Barley stocks were at critically low levels in August; Iran had reserves to last only 10 more days. Experts were speculating that the removal of the reference rate would lead to a doubling of the price of cooking oil, as Iran remains dependent on the import of cooking oil. Further rises in the price of chicken and meat products were also anticipated.

Investment Focus

Iran-Iraq-Syria pipeline: Economic Impact

The governments of Iran, Iraq and Syria signed a preliminary agreement in July 2011 to construct a natural as pipeline from the Iranian South Pars natural gas field to Europe. The pipeline would be routed through Iraq, Syria and Lebanon to an undetermined European entry-point. The Iranian Government in 2012 estimated the total cost of the pipeline as USD 10 billion. The project is a replacement for the now-defunct Persian pipeline project, that would have transported Iranian natural gas to Europe via Turkey and Greece.

Beginning sometime between 2018 and 2020, the proposed Iran-Iraq-Syria pipeline would transport up to about 40 billion cubic metres (bcm) annually from Iran, with most being delivered to Europe. This sounds like a welcome solution to Iran's natural gas export problem, but investors should be cautious with investments that are overly reliant on this export path.

The Russian South Stream and the Azerbaijani Trans-Anatolian projects are both further along, and they will cut into European demand for gas and reduce prices. Iran could find itself building this pipeline to serve a market characterized by declining prices. In addition, the project appears to be overly ambitious from a cost as well as schedule standpoint. Both Iran and Syria are currently subject to international sanctions, which will make financing very difficult. Furthermore, the Mediterranean crossing is beyond the technical capability of Iran, Iraq or Syria at present. International assistance will not be forthcoming until the sanctions are resolved.

Investors may be better served by holding fire until it is clearer that a deal can be done on Iran's nuclear programme. Even then, investments in Iranian liquefied natural gas projects that serve higher-priced Asian markets would appear to offer the prospects of higher returns.

Statistics

GDP Growth
-5-8% (VERITY estimate for 2013)
-1.3% (IMF estimate for 2013)
-5.9% (CBI measurement for 4th quarter of 2012)

Tehran Stock Exchange Main Index (TEDPIX)
28 October 2013 : 72215

Inflation
Estimated at 60%+ across Iran
Vs. Official figure: 40%

Unemployment
Between 30-35%
Vs. Official figure: 12.2%

Exchange Rates
Rial : USD 1
Reference rate: 12,275
Currency Centre (CTC) rate: IRR 24,825 : USD 1
Vs Unofficial rate: IRR 32,500 : USD 1