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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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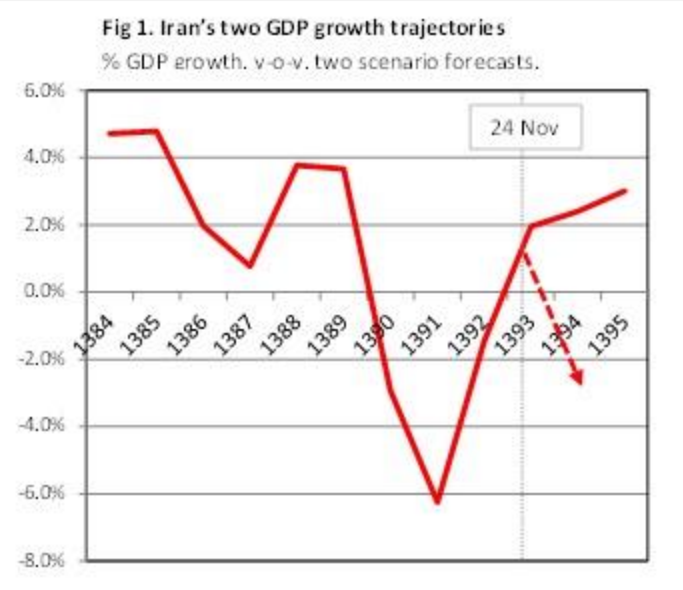
Crunch time for the Iranian economy

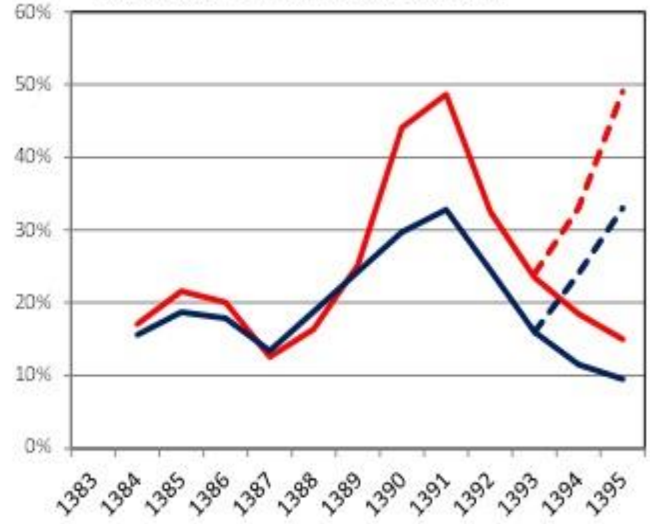
Despite some superficial signs of recovery, the outcome of next month's nuclear talks remains overwhelmingly important to Iran's trajectory. A breakthrough would spark an economic resurgence; a break-down, economic decline. The 20% drop in the oil price accentuates the importance of this round of talks even further.

With the deadline for nuclear talks less than a month away, now more than ever Iran is facing a bifurcated economic trajectory. If next month marks the breakthrough business people in Iran have been hoping for, the Iranian economy is likely to rebound rapidly. VerityIran economists predict a flood of Western investment, a rebound in confidence and renewed public spending within 6 -12 months. VerityIran's sources suggest multinationals and international investors have been laying the groundwork for a sanctions lift. Iran would see an immediate strengthening of the rial, which would reduce domestic inflationary pressures. The lifting of oil and financial sanctions would boost export revenues and provide a windfall for the public balance sheet. The re-opening of borders to Western partners would inject much needed technology and expertise into Iranian industrial production and revitalise Iran's outdated oil and gas fields.



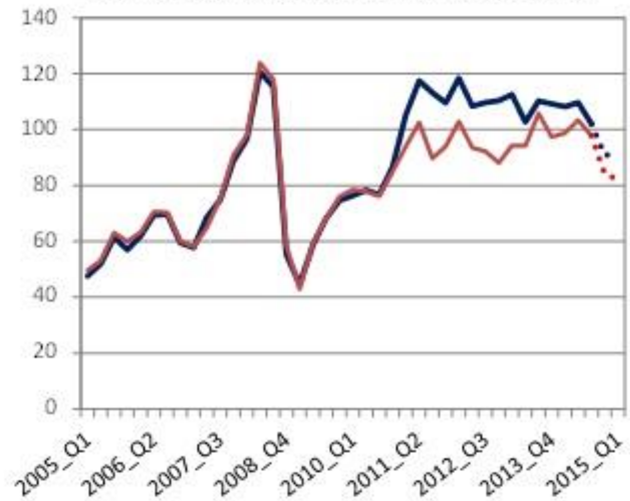
On the other hand, if talks finally fall apart next month, VerityIran predicts an immediate shock to confidence in the Iranian economy and a reversal of recent progress. VerityIran economists forecast a spike in capital flight and a sharp decline in the exchange rate under this scenario given the lack of protection available from Central Bank reserves. Investment would seize up and a very large wave of nonperforming loans could expose the fragility of the banking system, potentially with catastrophic effects for the financial sector. The Iranian economy is large and resourceful and would not simply run into the ground, but the short term would be very destabilising and the future bleak for the majority of businesses and households. Iran's enormous structural investment challenges – water shortages, dilapidated oil fields, antiquated telecommunications networks etc. would lose the prospect of any meaningful investment.

Fig 2. Iran's two inflation trajectories
CPI inflation, y-o-y, two scenario forecasts



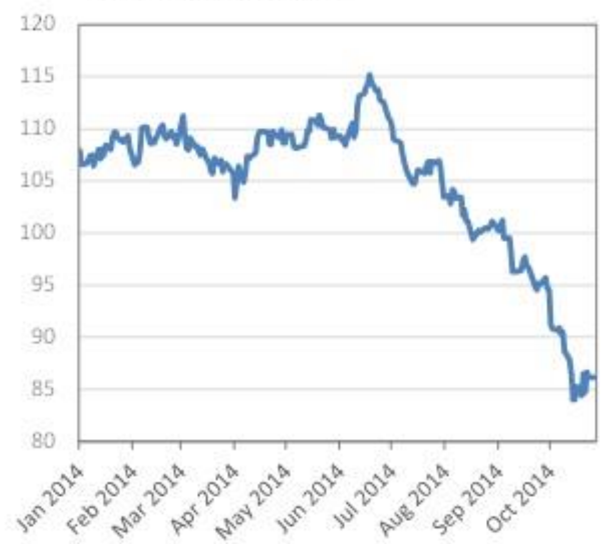
Meanwhile, the recent sharp fall in the oil price accentuates the significance of a nuclear deal. Brent crude prices have dropped to around US$86 per barrel, the lowest since 2010 (see Fig 3 and Fig 4). If sustained, this 20% drop in price would represent a monthly loss just short of $1 billion for Iranian export revenues. Due to constraints Iran already faces in accessing its oil export revenues, the immediate impact through crude oil exports would be subdued. Nevertheless, the effect would also be felt through Iran's more liquid revenue streams; refined petroleum, petrochemicals and black market crude sales are shrinking by the same order of magnitude.

Fig 3. Benchmark oil prices, quarterly average
Brent crude (blue), WTI (red), dotted line is forecast



This causes two problems. The first is further scarcity of foreign exchange in the Iranian economy, which tightens FX liquidity in the banking sector and raises the cost of imports. The second is the gaping hole this leaves in the public accounts. According to IMF estimates, oil revenues were set to constitute around two fifths of total public revenues in Iran this year. The authorities claim that $100 per barrel was required to balance the books. VerityIran estimates a break-even price closer to $130, not least given the official estimate was predicated on 1.5 million barrels per day sales which was over-optimistic. Vice

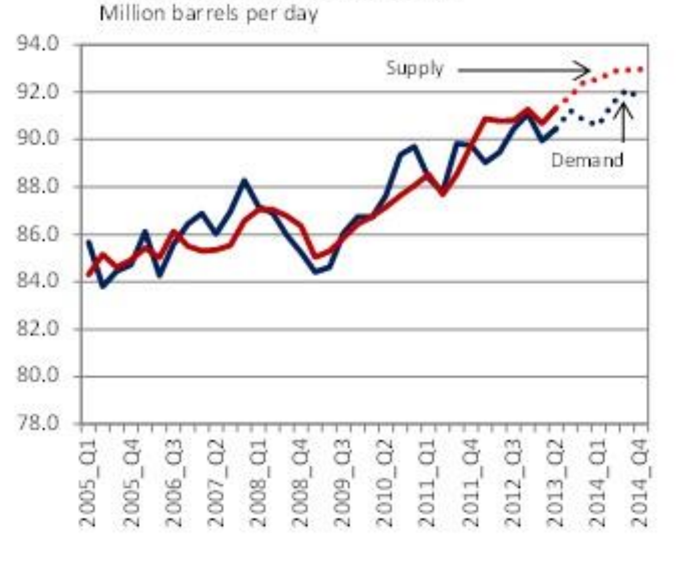
Fig 4. Brent crude oil price



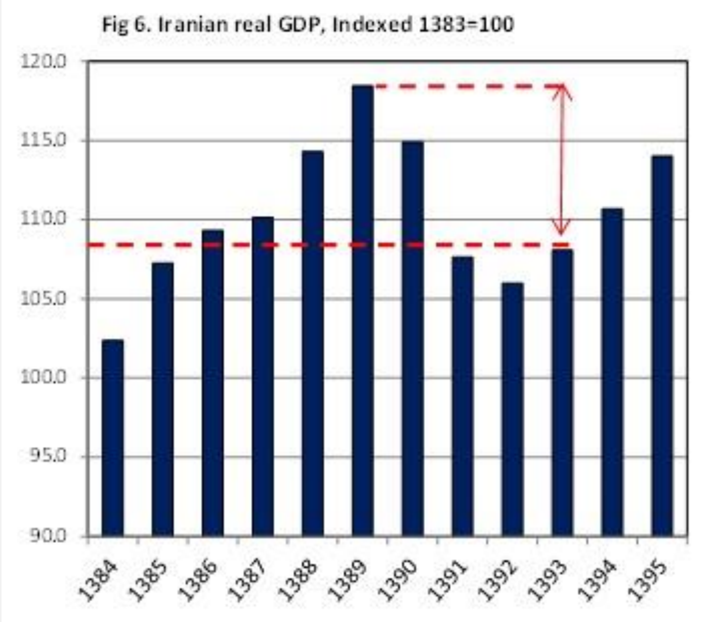
President Nobakht already trailed a lowering of this year's public spending ceiling after revenues from the first half of 1393 did not materialise as projected. Under such pressures, the government is likely to face some very painful spending decisions and may turn to the National Development Fund or even the Central Bank to meet the shortfall. If it does so the impact on rial liquidity would risk undoing the progress made against inflation in the past year.

Unfortunately for the Iranian leadership, the consensus view is that the price drop is driven by fundamentals so prices are likely to remain subdued for some time. The market is experiencing a slowdown in global demand and the highest crude oil output in 2 years, thanks to a surge in production out of Libya, Iraq, Nigeria, Angola and Saudi Arabia, not to mention the US shale oil boom (see Fig 5). In the context of the nuclear talks, the lower oil price would throw sand in the wheels of Iran's rebound as its plans to rapidly upscale production would depress prices further. In the event of no-deal on sanctions, Iran's situation is even more dire. Hawks in the Iranian system like to believe its customers, particularly in Asia, will not stand for further reductions on crude imports from Iran. But an oversupplied global market makes US terms on Iranian oil purchases much easier to accept. It also makes it easier for US lawmakers to justify an increase in oil sanctions to their domestic constituencies, who will be less worried about the impact on global prices. The longer oil production is depressed in Iran, the greater the risk of long-term damage to Iran's maturing oil fields.

Fig 5. Global Oil Demand and Supply



The Central Bank of Iran was able to issue some superficially good news on the Iranian economy in the last month, **surprising most Iranians with claims of a 4.6% year on year GDP growth rate in the first quarter of 1393**. VerityIran's economists see the announcement as misleading in the absence of substantial caveats. Firstly, the growth figure quoted for Q1 1393 is a "year-on-year" figure compared to the same period last year, which happened to be one of the worst performing quarters since the Iran-Iraq war. Fig 6 shows just how far off the real GDP levels of 1389 the economy remains. Secondly, it is important to question where the growth comes from before making assumptions about how sustainable it is. The growth appears to have been led by exports - reportedly up 8%, driven by oil and petrochemical sales – and will be buoyed by falling inflation and hopes for a nuclear settlement under Rouhani. All these factors are distinctly vulnerable to the outcome of nuclear talks and would undergo a harsh reversal if talks failed. Even the recent windfalls of liquid foreign exchange and the easing of export channels under the interim agreement with the P5+1 expires on the 24th November, with no commitment to an extension. The CBI's figures are good news for Iran but tell us nothing about the future of the Iranian economy after the 24th November nuclear talks deadline.



An extra glimmer of light came from the recent success of another ancient Iranian export – tourism. The number of foreigners visiting Iran reportedly jumped 35 percent in 1392, compared to a year earlier. The Minister for Tourism said 4.5 million tourists came to Iran, bringing in US$6 billion in revenue. Of a similar magnitude, Iran's steel sector also enjoyed a recent resurgence, exporting around US$6bn of merchandise in the year to July. Two success stories from two strategic industries, although both vulnerable to the outcome of next month's talks. Even if they handle the strait-jacket of sanctions better than most, they do not constitute an alternative to Iran's vulnerable fossil fuel economy. The combined income of these two sectors amounts to only around one fifth of projected oil and gas revenues for this year.

The Statistical Centre of Iran also released positive news on the labour market, claiming a drop from 10.7% under its definition of unemployment to 9.5%. Iran's murky parameters for employment accounting are well known but this month the World Bank fuelled the scepticism by pointing to unofficial estimates of unemployment at 20%. President Rouhani's Economic Adviser Nili was also careful to manage expectations about the jobs market. He warned of a significant lag in employment growth behind the recent GDP recovery, citing labour laws as the main constraint.

Certainly the "good news" emerging from Iran's statistics offices is ill-recognised and yet to embed itself in the day to day experience of the average Iranian household.