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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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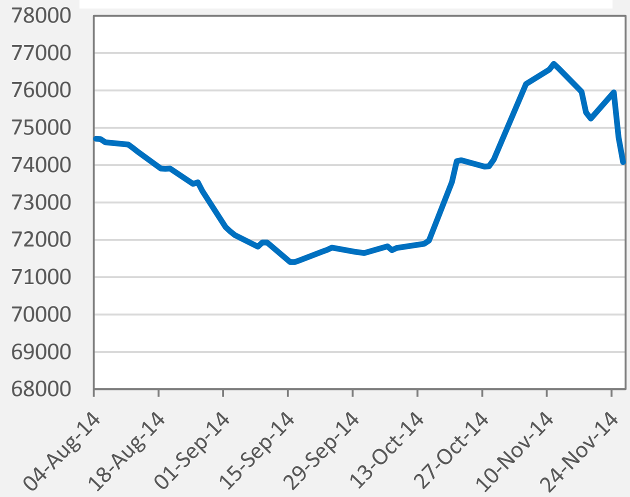
Crisis averted. Stagnation prevails

The decisive moment on *the future of the Iranian economy has been postponed by seven months as Iran agreed to extend nuclear negotiations with the P5+1. But Iranian businesses face another year of uncertainty and stagnation with enormous downside risks. The plunging oil price leaves a gaping hole in next year's budget and adds further pressure on the administration to seal the deal on sanctions.*

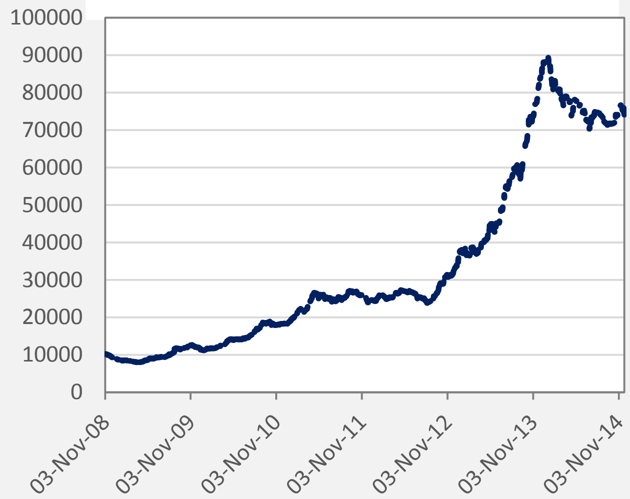
News of an extension to the nuclear negotiations delivered a sense of relief to the Iranian business community, closely followed by a more depressing sense of reality (Fig 1)**.** What does the extension mean for the Iranian economy? Certainly it postpones the risk of financial crisis that VerityIran economists believe would certainly accompany a breakdown in talks. But in reality it means seven more months of the same economic hardship: financial isolation, industrial stagnation, austerity and an acutely uncertain investment environment. The largest and most sophisticated sanctions regime in history remains stacked against Iran's energy and financial sector, affecting businesses across the entire economy. Foreign investors will stay away and domestic investment will remain largely on ice too. Real household spending will remain squashed under the pressure of falling real wages and fear over the future.

Fig 1. Iran's Stock Exchange (TEPIX) Daily index
(August 2014 to present)



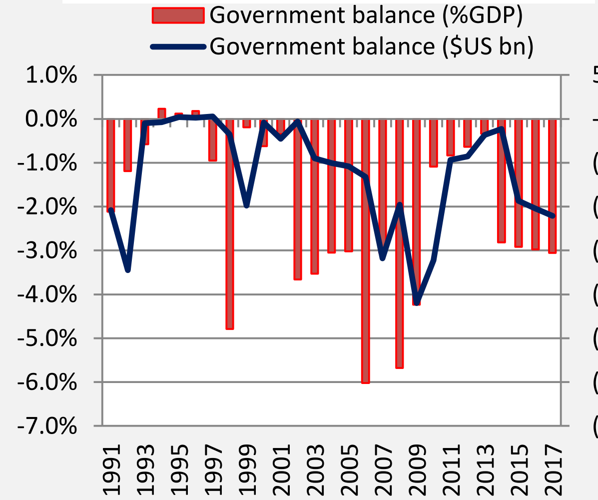
The extension means Iran is granted continued access to a monthly ration of its frozen assets, and most importantly keeps the chance of a comprehensive agreement alive. The US$700m monthly allowance from Iran's frozen overseas assets amounts to $4.9bn over the full period, which provides only relatively minor relief for Iran. For context, it compensates around two thirds of the losses Iran will face over the same period from the unexpected drop in oil revenues. This "financial life-line" will more likely serve to soften the oil price shock than to deliver a boost to the economy. The extension does mean Iranian businesses can expect a relatively stable operating environment for the next seven months, albeit not a comfortable one. And those expectations will be tempered by substantial downside risks, for example a sour-turn

Fig 2. Iran's Stock Exchange (TEPIX) Daily index
(November 2008 to present)



in the geopolitical atmosphere, or the flaring up of a domestic issue such as a bank-solvency or civil unrest. The prospects of upside risks are nil. One thing that has not changed since last week, is that a resolution to nuclear talks remains the only way of pulling the Iranian economy out of its funk and Iranian investors will remain focused on that.

Fig 3. Iranian Government Deficit projections
(based on previous price projections)

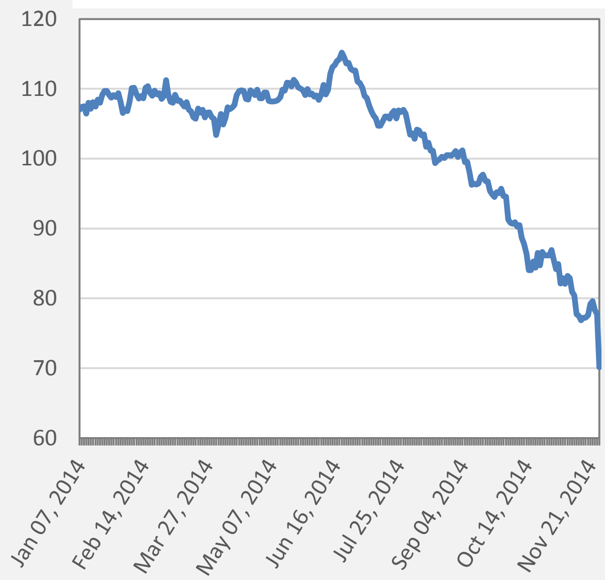


The oil price continues to languish, with no cuts to production from OPEC and signs that the price has not yet found its floor. VerityIran's sources have revealed that senior figures in the Iranian government are resigned to an extended period of low prices. Indeed, the Brent crude benchmark fell to $70pb at the end of November, a full 35% below the average price obtained in the first half of the year. It is worth noting that the effects of this price drop are only just being felt in Iran, where sales tend to be made in three-month contracts.

VerityIran economists expect to see real spending cuts in the upcoming budget announcement and a depreciation in the exchange rate. The latest statement from the Economy Minister, Tayb-Nia, suggested Iran is preparing the budget based on oil price projections as low as $70 per barrel (Fig 4). The size of the price shock means an increase in the budget deficit is most likely inevitable. VerityIran's estimates place the deficit at around 25% under reasonable assumptions and we expect it to be financed by borrowing, which will risk inflation. The government has talked publicly about dipping into the National Development Fund to meet the oil ministry's financial commitments in the wake of the revenue loss. It is not clear how plausible that is given that only last year the same administration bemoaned the Fund's emptiness, but if this money is used to finance government spending it will likely have inflationary consequences.

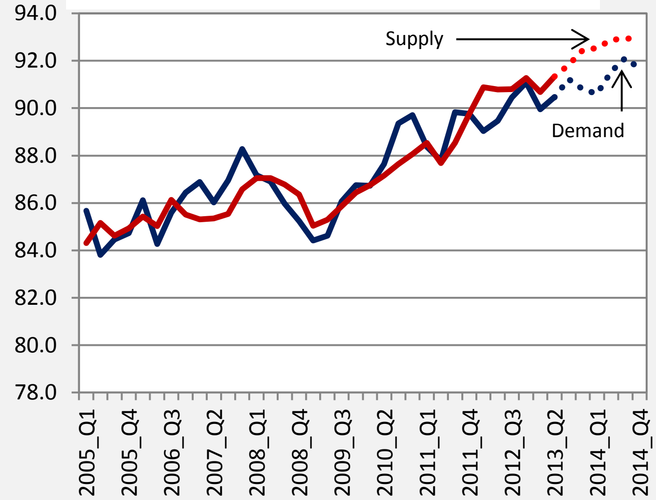
The prolonging of sanctions, the diminished oil price and the impending 1394 budget announcement again brings the Supreme Leader's idea of a "Resistance Economy" to the forefront. For VerityIran, the aspiration of reducing dependence on hydrocarbons and improving Iran's resilience to shocks is valid over the long-term but it has very little to offer in terms of short to medium term prosperity or relief to the ordinary Iranian household. As long as sanctions and isolation from the West prevail, there is nothing to fill the gap left by Iran's export revenues and inward investment. Financial stability will be ever more difficult to maintain. The industrial sector and its oil and gas producers will be starved of the Western technology they need to sustain and advance production. With the right domestic political environment one would expect Iran's officials to be able to stabilise the economy and, with time, proceed with constructive economic reforms. But realistically, following a breakdown in relations with the West, we would most likely see a return to prominence of Iran's more ideological figureheads and hopes regarding the role of the independent, technocratic policymaker would be diminished.

Fig 4. Brent Crude oil price (closing)
US$ per barrel



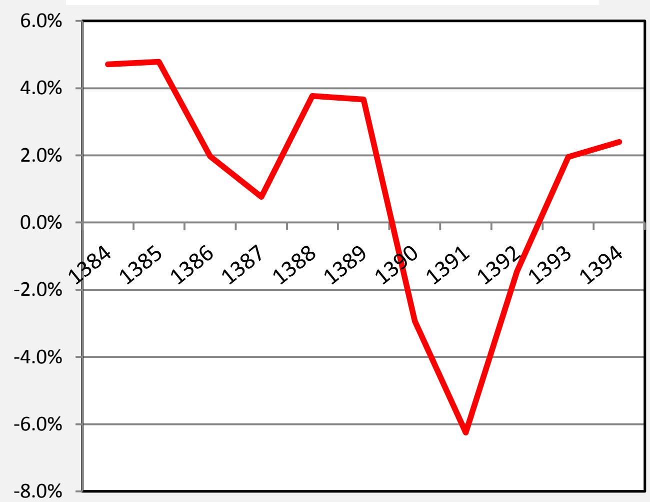
In the meantime, Iran's 16 million households cannot wait seven more months for progress in the real economy. By VerityIran's estimates, the economy contracted by a total of 10.6% in the past three years, a severely deep recession by international standards (Fig 6). Recent data suggested the economic trajectory has plateaued, but output has not recovered to anywhere near pre-crisis levels. Real household income levels were badly damaged by high inflation and remain under pressure. The official Consumer Price Index report for Aban suggested inflation was running at 22% y-o-y, up from the previous months. VerityIran's own estimates have inflation stubbornly hanging around the 30% mark, based on a combination of official statistics and street data. We also believe unemployment is much higher than the official rate of 9.6% reported by the authorities, and with 4.5 million students about to graduate, the jobs-market is about to come under renewed strain.

Fig 5. Global Crude oil excess supply
Millions of barrels per day, Demand and Supply



There are critical structural reforms that require urgent attention too: take the banking sector as an example. In the past decade, risk management practices have weakened, regulatory forbearance and graft have grown – capital adequacy ratios are endemically over-reported. And the sector is precariously exposed to non-performing loans amounting to at least 30% of the loan book – perhaps as much as double that if you believe Rouhani's senior adviser Torkan, who said in early-August that the figure was closer to Rls16tn (US$51bn). This is enough to render many banks technically bankrupt should confidence drop. The administration set the ball rolling on banking reforms with new rules on bank investments and a liberalisation of lending rates, both of which are designed to improve credit allocation. But averting crisis will require a deft balancing of risks and vested interests. The longer the sector goes on without a reopening of external lending channels, the larger the bad-loan book grows and the likelier the solvency crisis that brings the survival of the whole sector into question.

Fig 6. Iran GDP growth (y-o-y)
VerityIran estimates



Investors are concerned that the window of opportunity is surely closing for a comprehensive agreement: talks will not go on for ever. The new Republican-controlled Congress in the US appears eager to take a more prominent role in the negotiating process and is clearly unhappy with the continued rolling-over of talks. Hawks in the Republican Party are looking to impose new sanctions, not least to undermine President Obama's biggest foreign policy initiative. The seven month extension is more likely to be a four month opportunity to prove to conservatives that a comprehensive deal is possible and if we get to May 2015 without that, the real deadline may have already passed. President Rouhani's political capital also has a shelf life. The candidate that rose to power on the prospects of economic reform and a nuclear deal will not be able to maintain public support, nor offset Iran's own hawkish conservatives if prospects begin to fade. Truly, the extension has bought some time but the importance of a deal to the Iranian economy is higher than ever.