VERITYIRAN.COM
LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

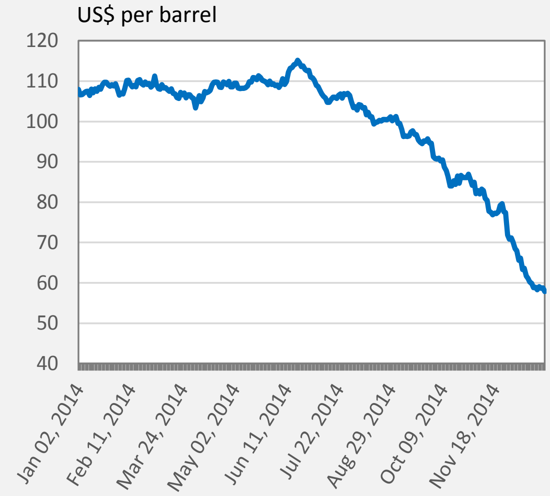
41 December 2014

Budget 1394: Spreading the pain (everywhere but security)

With the dust settled on the 1394 budget announcement, VerityIran reflects on a contractionary budget proposal that tries to spread the pain but will most likely lead Iran back to negative growth. Nuclear talks remain the potential game changer in both directions. The oil price shock is a distraction for an industry that is unable to repatriate so much of its revenues anyway. And the budgetary swing towards defence expenditure raises questions.

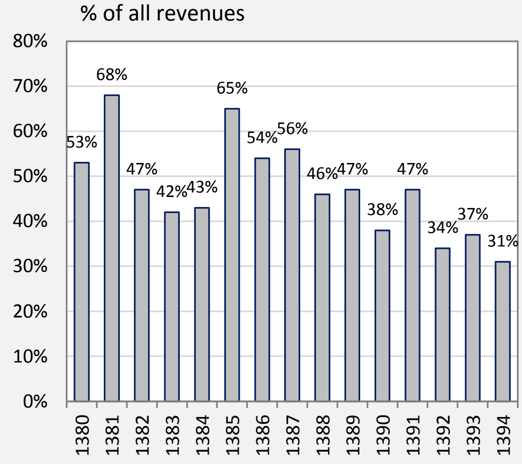
To give credit where it is due, the 1394 budget proposal was carefully considered in a difficult and uncertain economic environment. Comments preceding the budget announcement suggest the government was modelling a variety of possible scenarios for negotiations and oil prices and VerityIran believes this proposal is probably at the more pessimistic end of that range. It is austere, but there is a clear attempt to balance the pain across the economy, with the exception of the security forces who received a windfall.

Fig 1. Brent Crude oil price (closing)
US$ per barrel



The biggest headache for finance officials, among many, is how to deal with the recent and dramatic oil revenue shock. Brent crude prices dipped below $60 per barrel by the end of December (Fig 1). The 1394 budget assumes an oil price of US$72pb and by our calculations anticipates exports close to 1mbpd at that price. The assumed oil price for this year was US$100pb with the same level of sales so the 1394 estimate represents a huge drop in revenues. The oil industry has proved a cash cow for government revenues historically, providing 65% of revenues only 8 years ago (Fig 2). The share is forecast to fall to 31% in 1394, down from 37% this year. But this remains a vitally important revenue stream.

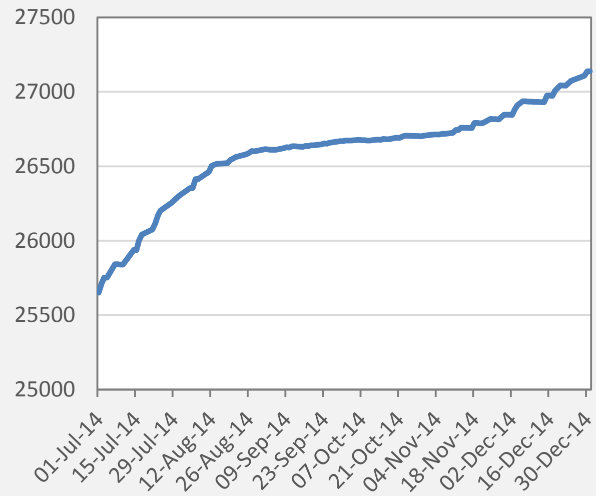
Fig 2. Oil share of government revenues
% of all revenues



The loss of oil revenues leaves a large hole, which has been offset in part by a gradual currency devaluation. This accounting trick boosts the rial-value of dollar-based oil exports and the 28,500 rials/USD exchange rate set for 1394 represents an 8.6% devaluation from the 1393 average to date. The authorities have been letting the rial slide gradually since July in anticipation (Fig 3). In addition, the government has made an effort to fill that gap with tax revenues, starting with a 2% increase in Value Added Tax from 8 to 10%.

In fact, Iran's finance officials face a much more complicated reality with regards to oil revenues. We know that oil export revenues have actually been tied up in large quantities overseas for the past three years, so the short term impact of a price drop is unlikely to be felt directly in government coffers. The rate at which Iran is allowed to repatriate overseas foreign exchange earnings is dictated by the interim agreement of nuclear talks and has not changed. And Iran has large enough surpluses with its oil customer countries to cushion the impact of any oil-price drop on bilateral barter trade. The more direct impact will be felt through Iran's illicit sales of crude and petroleum products. Iranian exporters continue to make some sales outside the scope of sanctions enforcement, which VerityIran's sources believe to be a fraction of the 1mpbd traded through open channels but still a substantial liquid revenue stream. By our estimates losses could to amount to billions of dollars annually if the low oil price is sustained.

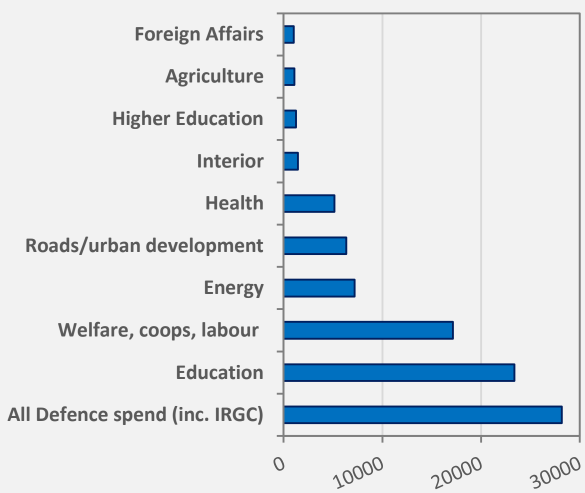
Fig 3. Rial/USD official exchange rate
01 July 2014 to 30 December 2014



Nevertheless, the theatre of a large oil price shock provides the government a convenient cover for some politically sensitive budget decisions. Public sector wages have been cut in real terms, consumption taxes have increased, subsidies removed, welfare payments frozen - including the controversial cash compensation payments. All of these measures heap further pain on the average Iranian household, which has been labouring under austerity for multiple years now. The much publicised 4% increase in total spending actually represents a large contraction in real terms, when adjusted for inflation. That is on top of an already austere budget this financial year. We interpret the 1394 budget as an approximately 8-10% real fall in total spending. The majority of that fall seems to be accounted for by the much larger state enterprises and banks budget.

In an austerity budget that has clearly attempted to spread the pain, Rouhani's government has handed a big boost to defence and security forces, with a 32.5% increase. Fig 4 shows how Defence spending already constitutes the largest budget line, above the key ministries of education, welfare and health. And Fig 5 breaks down that spending further. The largest increase goes to the IRGC, whose budget has risen by 50% and now dwarfs other elements of the defence architecture. VerityIran economists are not expert on Iran's defence policy or strategic security challenges, but the vast diversion of resources to an entity with such a strong reputation for corruption at a time of such scarcity is questionable. Some commentators suggest Rouhani has moved to prioritise security and regime preservation over economic welfare in the coming year, as insurance against rising tensions if talks break down.

Fig 4. Ministerial budget allocation
Bn Tomans

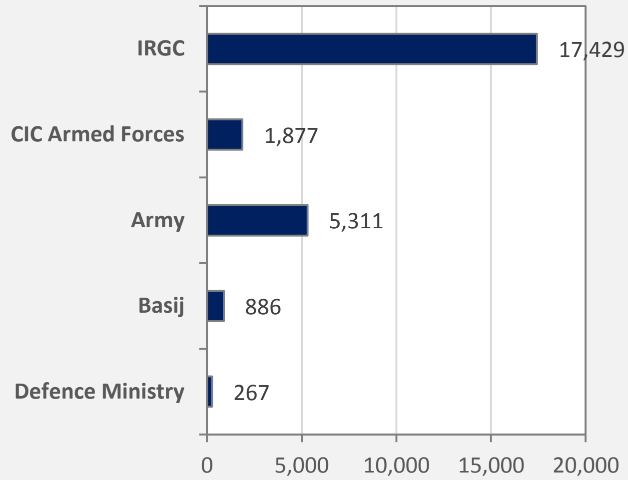


Conspicuous in its absence from the government's discussion of the 1394 budget is the size of the deficit and how it will be financed. Granted, the authorities will want to avoid issuing too much detail given the considerable uncertainties over oil and tax revenues in this period, but there must be a plan in place to finance spending. The government is facing a very large deficit in the 1394 budget under current assumptions, especially in cash terms as so much of the government's assets are locked up overseas. This means considerable borrowing, probably from the central bank. Combined with the rise in VAT, the removal of subsidies on fuel and food, and the devaluation of the rial, this will be inflationary and the government's prized claim of fixing the inflation problem is likely to unravel.

Overall, this is a contractionary budget for uncertain times. In the absence of a successful outcome from nuclear talks, VerityIran expects it to return the economy to negative growth. Given the financing challenges, we expect a fresh burst of inflation too. The budget shrinks aggregate demand on multiple fronts: reducing government spending, squeezing household incomes and taxing consumption. There are enormous downside risks to the assumptions underpinning spending levels: a potential further drop in oil prices, a failure to reach tax revenue projections, a banking crisis or run on the rial to mention but a few. Fig 6 shows VerityIran's revised GDP growth forecast under the base-case scenario to 1395.

Fig 5. Defense expenditure

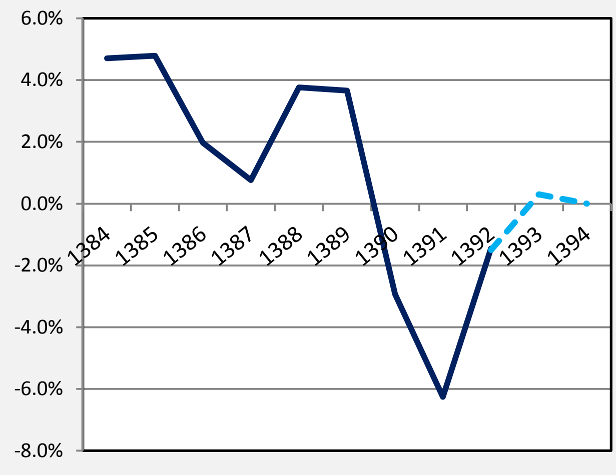
Bn Tomans



In other developments, the Central Bank moved to consolidate interest rates with a 2% rise in the short term deposit rate. With official inflation currently stated as 17%, this generates a positive real interest rate (with the rate of interest above inflation) for the first time in many years – a genuine incentive to savers and a bid to slow down liquidity growth and shore up the banking system. As we reported in last month's report, non-performing loans are so high that most banks are threatened by insolvency. Rouhani's senior advisor Torken has described it as a "hidden bankruptcy", suggesting the majority of banks in Iran are only afloat thanks to Central Bank aid. This is a positive small step to protect the sector from future risks.

Fig 6. VerityIran GDP Growth forecast

(% y-o-y real GDP growth)



And finally, the late December move by the US Treasury to slap new sanctions designations on 3 Iranian entities and 6 individuals is a reminder for Rouhani's economic team of the pertinence of nuclear talks. US Treasury officials insist they are adhering to the principle of holding back on new sanctions whilst nuclear talks are ongoing, and that these measures are only the enforcement of existing sanctions (relating to circumventing financial restrictions on the Central Bank and human rights abuses). Nevertheless, as the new political year gets underway in the United States, the newly established Republican-dominated Congress has been clear about its intention to ratchet up the pressure on Iranian negotiators. The threat of Presidential veto against Congressional legislation is much less reliable in a congress where only 12 Democratic votes are needed for a "veto-proof" two-thirds majority vote. And many US hardliners would like to push such a majority through to see further pressure placed on the Islamic Republic. The clock is ticking on US political goodwill towards the nuclear negotiations. The next talks commence on 15 January.