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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY



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In this Issue

- December Overview
- Negotiations continue on implementation of Geneva agreement
- US designate Iranian entities under existing sanctions
- Draft budget for next year presented to the Majles
- Stock exchange reaches new highs
- Iran struggles to recoup foreign currency portion of Indian oil payments
- US oil waiver extended for China, India and South Korea
- Iranian data reveals growing discrepancy between oil sales and revenue
- Turkmenistan unable to collect Iranian debts owed for 2012-2013 gas imports
- CBI announce intention to introduce new transparency focus
- Investment focus: Iran's emerging real estate bubble
- Statistics

December overview

Negotiations continue on implementation of Geneva agreement

In several long sessions between the respective technical delegations, Iran and the E3+3 have attempted to reach an agreement on the implementation of the Geneva deal, a necessary first step to discussions beginning on the comprehensive settlement. At time of writing no final agreement has been reached though both sides claim publicly that progress has been made. Contentious issues, such as Arak and the development and installation of advanced centrifuges are likely to remain the key sticking points. It seems likely that agreement on these issues will require further discussion at a more senior political level in early January.

Nevertheless, it has emerged that both sides expect the implementation of the Geneva deal to begin on 20 January, subject of course to final agreement on the outstanding issues. Without agreement on these issues before 20 January, it is difficult to see implementation beginning on time. Neither side will want to roll-over these issues into the negotiations on the comprehensive settlement, for fear of presenting opportunities to the deal's opponents to derail it completely. Both sides have invested much political capital in the deal, however, and have much to gain. It appears likely that a compromise will be reached, allowing implementation to begin on, or shortly after, 20 January.



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US designate Iranian entities under existing sanctions

On 12 December, the US Government announced an expanded list of Iranian companies and individuals that it had designated under existing sanctions. The move was widely reported as an effort to demonstrate to its allies, as well as to Iran, that the US remains committed to keeping the pressure on Iran. Despite advanced notice that the designations were coming, the Iranian Government reacted badly to the announcement, temporarily withdrawing from the talks on the implementation of the deal.

The Iranian reaction showed the fragility of the Geneva deal. There appears to be a disconnection between the different sides' interpretations of what the Geneva deal represents. From the US Government's perspective, very limited relief from sanctions was offered to build trust and in return for the Iranian Government addressing some of the E3+3's most pressing proliferation concerns. Existing sanctions must be strictly enforced in order to preserve the integrity of the deal. The Iranian Government, however, appears to have interpreted the Geneva deal as the first step towards the complete relaxation of international sanctions against Iran. Iranian officials have been actively reaching out to potential partners in the weeks since Geneva, in an effort to attract new business.

It is clear that, if implemented, the Geneva deal does offer investment opportunities in certain sectors, such as petroleum products. However, investors should remain cautious of over optimism. The vast majority of the sanctions architecture remains in place. The US Government's commitment to enforcing those sanctions means that the risks of general trade with Iran now, and before a comprehensive settlement is reached, are much the same as those that existed before the Geneva deal was struck.

Macro economic news*Draft budget for next year presented to the Majles*

On 8 December 2013, President Rouhani presented his first full draft budget bill to the Majles. The overall draft budget, comprised of the government's current spending and development projects, is worth the equivalent of USD 78.6 billion, a 30 percent rise compared to the revised budget for the current fiscal year according to *The Financial Times* online. The draft budget envisages an increase in Government spending of 16 percent, far lower than the official inflation rate of about 40 percent. As expected, Rouhani's draft budget does not address the highly contentious issue of subsidy reform. Rouhani has promised a separate bill on subsidies to be put forward soon.

In presenting the draft budget for the next Iranian year (beginning on 21 March 2014), Rouhani said that unemployment and stagflation were Iran's main economic challenges, compounded by increasing money supply by the CBI and tough international sanctions. Rouhani said that his government would seek to encourage investment and entrepreneurs, and fully implement privatisation plans. The Speaker of the Majles, Ali Larijani, praised Rouhani for presenting the draft budget bill on time, and said that it reflected fairly accurately Iran's economic situation. The Majles will now consider the draft budget bill in detail.

Alongside the presentation of the draft budget, public statements by Vice President Nobakht have provided additional details on the plans the government has drawn up for the next year. Nobakht has suggested the Government has planned for three scenarios depending on the outcome of the E3+3 negotiations (status quo; removal of sanctions; imposition of additional sanctions.) Nobakht's statements reveal a readiness to adapt to the situation. Flexibility will be important given the uncertainties surrounding the course of events before the end of next year.

Alongside uncertainty about the outcome of the ongoing E3+3 negotiations, it is not known how the promised separate bill on subsidy reform will play back into the main budget. Moreover, it is not yet clear that the government will raise the revenue from oil sales and taxation that the budget predicts. In the current year, revenue shortfalls have



meant that development spending has slowed to a trickle and much of the budget appears likely to end up unspent. It will be the availability of revenue, rather than plans made in advance, that will determine whether or not the Government is able to fulfil its spending promises made in the budget.

Stock exchange reaches new highs

The main index of Iran's stock exchange, the TEDPIX, climbed to a series of new highs in December, reflecting the new atmosphere of optimism in the market following Rouhani's election and the improved prospects of a nuclear deal. The TEDPIX has risen from 58,000 when Rouhani was inaugurated, to over 89,000 during December.

Rouhani appointed a good economic team and made improving the economy his domestic priority. He has kept promises on presenting progress reports and draft budgets, and been far more transparent than his predecessor about the dire situation of the economy and his strategy for turning it around. In policymaking terms, Rouhani's approach represents a transformation, and the start he has made to reforming the economy has been impressive.

It will take time to repair the economy. The economic mismanagement of Ahmadinejad can not be undone immediately. Government debts have to be serviced, and spending commitments, however extravagant and populist, cannot all be dismissed without risking criticism and possible unrest. Crucially, the economic fundamentals, including high inflation and unemployment, remain poor, and most observers believe the economy is still contracting. All of which raises questions about the sustainability of the stock market's rise. If, as seems likely, it is mostly optimism about the prospects for a nuclear deal that is fuelling the rise, the stock exchange's new high may yet prove precarious. Investors will be cautious about reading too much into the stock market's new levels.

Banking news

Iran struggles to recoup foreign currency portion of Indian oil payments

The effect of the devaluation of the Indian rupee on Iranian rupee holdings in India's UCO Bank has been widely reported, and estimates as to the extent of Iranian losses have varied widely. Less widely reported have been the difficulties Iran has had in recouping the portion of revenue from Indian oil sales in foreign currency. Iran has an agreement with Indian officials for the payment of Iranian oil in an undetermined ratio of rupees and euros. But Iran has struggled to recoup the portion in euros, or any other foreign currency, as a result of international banking sanctions. Alongside the cost savings involved in making payments in its own currency, India's inability to find a mechanism to transfer the foreign currency portion of its payments helps to explain India's keenness to increase the portion of the payments for Iran's oil in rupees. However, with its stockpiles of rupees growing, and given the losses Iran has already had to sustain as a result of the devaluation of the rupee, Iran is unlikely to accept any increase in the proportion of Indian payments in Rupees in the foreseeable future.

Oil and gas news

US oil waivers extended for China, India and South Korea

On 29 November 2013, the US State Department announced that it has extended sanctions waivers to China, India and South Korea to purchase Iranian oil. The extension of the sanctions waivers were widely expected, following Chinese, Indian and South Korean adherence to strict limits imposed by the US on imports of Iranian oil. The limits, designed to decrease exponentially at six-month intervals, have been frozen at their current levels under the terms of the agreement reached in Geneva in November.

VERITY has learned that Iranian crude export totals during the period January – October 2013 averaged nearly 1



million barrels per day. China has remained Iran's biggest crude customer, accounting for nearly 40 percent of Iran's total crude exports. Iran's other important customers include India, Japan, South Korea and Turkey.

Iranian data reveals growing discrepancy between oil sales and revenue

Iranian data obtained by VERITY has revealed a growing discrepancy between oil sales and the revenue generated as a result of sanctions. Comparing the periods from March – September 2011 with March – September 2013, the data revealed that oil sales had decreased by 55 percent, while revenue was down by 60 percent. Sanctions against Iranian banks and Iran's effective exclusion from international banking systems have limited the procedures available to Iran to receive oil revenue. This discrepancy will have been of particular concern as the Government reviewed its future spending plans as it drew up its budget for the next year. Projections for foreign currency receipts will have been revised downwards. Iran will have to barter for basic goods, or risk the funds remaining in overseas bank accounts beyond its reach for as long as sanctions remain in force.

Turkmenistan unable to collect Iranian debts owed for 2012-2013 gas imports

According to VERITY's sources, Turkmenistan has been unable to collect Iranian debts owed for gas imports during 2012-2013, amounting to millions of US dollars. Turkmen officials are considering their options, but so far no decision has been made on whether to suspend gas exports to Iran.

Other news

CBI announce intention to introduce new transparency regulations

In early December, in a move likely to please investors, the CBI announced its intention to introduce new regulations aimed at improving transparency and reducing ambiguity in the way that Government assets are dispensed to holding companies and investment companies. The new regulations followed the publication of a report on corruption in the way that the Social Security Organisation's assets were transferred to the private sector.

Investment Focus:

Iran's Emerging Real Estate Bubble

It is a well-known cautionary tale. In 1634, a tulip bulb could be bought or sold for about 1 Dutch guilder on the Amsterdam exchange. By the winter of 1636-1637 the price had risen to about 60,000 guilder per bulb, at which point the bubble burst. Within days the price had dropped a hundred-fold, and in a matter of months, it was less than 1 guilder. A full-blown economic panic was underway that put Holland in a depression lasting several years. The problem, of course, is that tulip bulbs do not enhance economic productivity, and hence have no underlying value.

Iran finds itself with a similar problem. Soon after the onset of sanctions, wealthy Iranians hedged against devaluation and inflation of the Rial with hard-currency based investments and gold purchases. Once the government closed this avenue, property became the investment of choice. The soaring appreciation in property values of the past few years is supported not by underlying economic value, but rather by investors' unsound reasoning that they will be able to sell these assets later at a higher price – like the tulip bulbs. Investors should be wary of real estate and focus their attention on helping the government ease sanctions, which would allow funding of more sustainable investments.

Statistics

GDP Annual Growth Rate



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2014: 1.3% (IMF estimate for 2014)
2013: -1.5% (IMF estimate for 2013)

Tehran Stock Exchange Main Index (TEDPIX)
31 December 2013: 88313.38

Inflation
Official figure: 35.5%

Unemployment
Official figure: 12.6%

Exchange Rates
Rial : USD 1
Reference rate: 12,275
Currency Centre (CTC) rate: 24,794
Open Market Rate: 29,950

