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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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VERITY FOCUS

Focus on nuclear negotiations ahead of 20 July deadline

Negotiations between Iran and the E3+3 on a comprehensive agreement on Iran's nuclear programme remain the focus of investor attention. The target for all sides is to reach agreement in advance of the 20 July expiry of the Joint Plan of Action. Few specifics of the discussions have been released, but the mood music emerging from Vienna, where the talks have been occurring, is no longer as upbeat about the prospects for a deal before 20 July as previously reported.

Progress is being made, albeit slowly, according to media reporting. The drafting stage is underway. However, both the E3+3 and Iran appear to remain far apart on key issues, such as over the enrichment capability Iran will be permitted by the E3+3 to retain, and on the future of the IR-40 heavy water plant at Arak. If there is no agreement by 20 July, both sides will need to be close enough to a comprehensive deal to make a roll-over worthwhile. The next 20 days will be crucial. Investors will be watching the newswires carefully.

Economic prospects in deal or no deal scenarios

For Iran, there is a stark difference in economic outlook depending on whether it can reach a compromise agreement with the E3+3 or not.

To set the context, since coming to power last summer President Rouhani's government's economic performance has been good. He appointed a competent and experienced economics team to set about turning the rapidly sinking economy around. He prioritised reducing inflation, which he has started to do. He has set in train reforms, such as the targeted subsidies reform programme, which will bear fruit if fully implemented and adhered to in the medium to long term. And he has improved transparency in policy making, which has improved investor confidence. Perhaps most significantly, by engaging in talks with the E3+3 and agreeing the interim agreement, Rouhani has provided breathing space and a period of stability of at least 6 months allowing his government to introduce its reforms. The period of stability provided investors with a window of relative certainty in which to make plans, and to take short term investment decisions.

The effect of Rouhani's efforts, and particularly of the breathing space provided, has been to slow the pace of economic decline rather than to return Iran to growth. The low-hanging fruit has now been picked; the choice facing Iran is whether to reach further in the promise of bigger and more sustained improvements. Iran's economic outlook is dependent on developments in Vienna. It is possible to envisage three different scenarios unfolding, depending on the outcome of negotiations: a comprehensive agreement, a rollover, and failure to reach agreement:

- *Deal:* Successfully reaching a comprehensive agreement ultimately leading to complete nuclear sanctions lift would lead to an early surge in confidence in the market, and an immediate improvement in the exchange rate. The extent to which the economy would improve over time would depend on the speed and sequencing of sanctions lift and the progress of economic reforms. But with Rouhani's capable team of economic managers in place, Iran's ability to respond to sanctions lift in the short term is not in question. Economy Minister Ali Tayebnia recently suggested that Iran had the capabilities and capacity to grow at 8 percent or more per year. The IMF's reported suggested a more conservative estimate of 6 percent was more likely. What is not in doubt is that the Iranian economy has the potential and the likelihood of returning to strong and sustained economic growth in the event of a comprehensive agreement and a wholesale removal of sanctions.

- *Extension:* A rollover of a few months to give more time for the two sides to agree, without significant new sanctions relief, would lead to little, if any, immediate improvements. In this scenario, trade would continue to be depressed by sanctions. Growth would remain static, while unemployment would rise as new graduates enter the job market. Households would be put under pressure as a result of increases in inflation caused by a probable depreciation of the exchange rate and the recent sharp energy price increases. A longer extension of the Joint Plan of Action stretching to the end of the year or beyond is unlikely. It would be opposed by hardliners on both sides, who would attempt to undermine negotiations, for example by introducing new sanctions measures. The deal would inevitably fall apart.

- *No deal:* In the event that Iran fails to reach a deal with the E3+3, the result would be an immediate and negative impact on confidence. The exchange rate would drop sharply and investment would fall in line with market prospects. New sanctions measures would almost certainly be introduced by US Congress, coupled with renewed efforts to enforce existing sanctions. Iran's economic policy would be required to adapt to an indefinite period of isolation, while Iran's population would have to brace themselves for further economic decline and contraction. In time, sound economic management may see Iran return to sluggish growth, but well below Iran's potential and probably not enough to avoid steadily rising unemployment. In this scenario, Iran's economy would face years of poor performance.

In pure economic terms, the reasons for Iran to reach a comprehensive agreement with the E3+3 are irrefutable. Moreover, time is not on Iran's side. As US Treasury spokesman Jack Lew recently pointed out, Iran is losing a significant amount in oil sales from sanctions, vastly more than the value of the temporary relief. Iran's economy remains in the state of distress that brought the government to the negotiating table in the first place. For all his claims that this will be a year of economic prosperity whether there is a nuclear deal or not, President Rouhani realises the critical importance of a comprehensive agreement. The decision on Iran's nuclear future, however, is a political one to be made by Iran's Supreme Leader. Investors will be watching closely to see what he decides.

JUNE NEWS ROUNDUP

Macro economic news

Foreign currency shortfall may force budget cuts

VERITY has learned that official financial forecasts for foreign currency revenue in 1393 (year ending 20 March 2015) have predicted a significant shortfall on the budget estimate. The government had targeted an income from total exports of nearly USD 30 billion in foreign currency; but, based on current sales and income, with trade still critically depressed by international sanctions, Iran is facing a shortfall of more than USD 5 billion. The shortfall is significant, particularly when considered alongside the projected shortfall in tax revenue, as reported in VERITY 34. The reduction in the level of income will force the government to reassess its spending plans, or place key policy goals (such as a reduction in inflation) in jeopardy. However, the year is barely 3 months old. With sanctions lift resulting from a comprehensive agreement on the nuclear issue, Iranian trade would experience a tremendous boost. There is still scope for a recovery in Iranian exports.

Inflation decreases to 16 percent

The Iranian government has succeeded in curbing inflation to 16 percent in May, according to Economy Minister Tayebnia. Official statistics show that inflation has fallen from 45 percent in May 2013 (though many analysts believed inflation was actually far higher), to 16 percent in May 2014. Decreasing inflation has been a priority for President Rouhani's government, and its most visible economic achievement to date. It will help to improve business expectations, and increase investment prospects in the medium to long term.

According to VERITY's own estimates, however, the consumer prices index in Iran has increased by 2.5 percent in June 2014, compared to May 2014. This is the first month-to-month increase of more than 2 percent VERITY has recorded since October 2013. The increase is likely to be temporary, and fuelled by the increases in energy prices announced in March 2014 starting to take effect.

Continued decline on the stock exchange

The Tehran Stock Exchange has continued its steady decline. From a peak of 89,500.6 on 5 January 2014, the exchange was trading at 72249.9 on 26 June, a fall of nearly 20 percent. Analysts attributed the fall to the ongoing recession, and uncertainty surrounding the outcome of the nuclear talks.

Banking news

Bad debt levels higher than announced

The level of defaults in the Iranian banking system is significantly higher than previously acknowledged, according to figures provided by Economy Minister Tayebnia. The real figure for bank defaults is IRR 1,500 trillion (the equivalent of USD 58 billion calculated at the official rate). This is IRR 680 trillion (USD 26.6 billion) higher than the figure the equivalent of USD 33 billion announced by Vice President Eshagh Jahangiri last month (see VERITY 34). Working on CBI estimates that reckoned USD 33 billion accounted for 15.6 percent of total bank loans; USD 58 billion represents more than 25 percent of total bank loans. The increased estimate makes it even more important to recoup some of this debt if Rouhani is to balance the books, afford his reforms, boost employment and raise living standards.

Oil and gas news

Delays in development of South Pars Gas Field

VERITY has learned that development of the South Pars Gas Field is experiencing major delays. The delays have been attributed to an historic lack of investment in the natural gas sector. VERITY understands that senior Iranian oil officials have taken a personal interested in South Pars in an effort to speed up development.

Oil Minister Bijan Namdar Zanganeh announced on 20 June that a further USD 20 billion would be required to complete the South Pars Gas Field project within 3 and a half years. Zanganeh said that USD 30 billion has already been spent in developing the gas field.

Other news

Government bodies banned from importing domestically available goods

The Iranian government has recently issued a new directive effectively prohibiting government agencies and publicly-funded bodies from importing goods when there are domestically-produced equivalents available. The Iranian government's intervention is consistent with reports of the shortage of foreign currency, and a desire to avoid unnecessary foreign currency expenditure. The depreciation of the open market exchange rate by over 10 percent, from a high of IRR 29,500 against the US dollar in January and February, to about IRR 32,000 in June 2014, also points to difficulties accessing foreign currency to support the exchange rate level.

Statistics

Statistics

GDP Annual Growth Rate

2015: 1.5% (IMF estimate for 2014-2015)

2014: -1.7% (IMF estimate for 2013-2014)

Tehran Stock Exchange Main Index (TEDPIX)
27 May 2014: 72249.9

Inflation:

Official figure: c16%

Unemployment:

Official figure: c.10.4%

Exchange Rates:

USD: IRR

Currency Centre (CTC) rate: 25,630

Open Market Rate: 31,950